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Gary M. Anderson and Adam Gifford Jr. — Order Out of Anarchy: The International Law of War

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BOOK REVIEWS

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The Challenge to the U.S. Postal Monopoly, 1839–1851

Kelly B. Olds

Over the last decade, government postal systems around the world have been facing increasing competition largely stemming from the rise of alternative technologies. During the years 1839–1851, the United States Post Office was in a similar situation. Private competition arose that made effective use of railroad and steamship lines. This competition was so successful that a number of congressmen feared postal service was on the verge of an involuntary privatization. Because the monopoly profits garnered by the Post Office were important to politically powerful interest groups, the federal government did not allow postal service to be privatized. To eliminate private competition, however, the government was forced to reduce drastically postage rates and adopt many important reforms. The postal system arguably underwent more change in those 12 years than in the rest of its history.

The Post Office was the largest commercial enterprise in the antebellum United States. By mid-century, it employed 20,000 individuals. In 1831, three-fourths of all civilian federal employees worked for the Post Office. By the time of the Civil War, that fraction had risen to almost five-sixths (*Historical Statistics of the United States* 1960: 7, 710). Almost all of the employees were deputy postmasters or clerks. The majority were part-time. An even larger number of people worked under contract or for companies under contract to the Post Office. The contracts were mainly for transportation.

The Post Office's monopoly power allowed it to earn huge profits (or "rents") on important routes because few close substitutes for

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mail service existed. In many other countries, the national postal service earned significant revenue for the government's general fund. In Great Britain, the expenditures of the postal service during the 1830s yielded a profit of approximately 200 percent. The U.S. Post Office returned almost no revenue to the general fund. It usually reported losses. Large profits were being earned, but they were distributed internally. Giving out the postage revenues to groups with political power became the Post Office's second function. Measured monetarily, it was the Post Office's primary function. Thomas Jefferson, suspicious of the Post Office, had written:

> I view [the Post Office] as a source of boundless patronage to the executive, jobbing to members of Congress and their friends and a bottomless abyss of public money. You will begin by only appropriating the surplus of the post-office revenues; but other revenues will soon be called in to their aid and it will be a source of eternal scramble among the members, who can get the most money wasted in their states; and they will always get most who are meanest [Jefferson 1892–99: IX, 324–25].

The government resisted subsidizing the Post Office until the 1850s, partly out of fear of that which Jefferson prophesied.

The Post Office's large hidden profits caused very high postal rates relative to the cost of transportation. Before the first price reform in 1845, the average one-page letter cost 14.5¢ postage (Post Office Department 1844). It was often noted in the New York press that one could ship a 200-pound barrel of flour down the Hudson from Troy to New York City for less than one could send a one-page letter over the same route (*New York Tribune*, 30 October 1843). The high postage was felt to be oppressive—especially after 1839. In 1839, the British reformed their postage system, dropping the postage charges from an average of 15¢ American to a flat rate of 2¢ per letter. Even more important, it was in 1839 that the U.S. Post Office first came up against significant formal competition.

Private companies deliver mail efficiently and at low rates. To defeat the private mail and express companies, Congress was forced to lower postage rates. Rates were lowered to an average of 6.3¢ per half-ounce letter in 1845. Private competition and postal reform agitation were temporarily checked, but did not cease. In 1851, Congress lowered postage further, to 3¢ per half-ounce letter.

Congress managed to avoid the privatization of postal services. Private competition, however, permanently changed postal service in America. Not only did it cause a drastic reduction in price, but it proved

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the usefulness and profitability of new techniques and services—such as postage stamps and intra-city delivery—which the Post Office then copied.

Operation of the U.S. Post Office

The U.S. Post Office transported consumers' mail between post offices. On busy routes, mail was delivered once or twice a day, but in smaller towns mail might be delivered as seldom as once every other week. Mail service can be considered a special form of transportation. It was much more expensive than the transport of freight or people. The average cost of transporting a one-page letter in 1843 through the Post Office was 14.5¢. The average one-page letter weighed .25 ounce and traveled less than 500 miles, so the cost exceeded $35 per ton-mile (Post Office Department 1844) or about 140 times freight rates on New England stage coaches ("Post Office Monopoly" 1843: 484). Even the least expensive private mail companies never charged less than 2¢ on intercity mail.

The reason for the high cost of postal service was two-fold. First, high sorting costs and the obligation to run fixed routes at fixed times carrying nonoptimal loads raised the cost of all formal mail services. The greatest expense of regularity came in rural regions where a sulky or horseman was often dispatched with a handful of letters. A route that generated too little revenue compared with its expenses was supposed to be cut back or discontinued but, in practice, the decision to cut back or abolish a route was often political.

The second and most important reason for the high cost was that postage served as a tax. The Post Office may not have been designed with this purpose in mind, but collecting monopoly rents (i.e., revenues in excess of opportunity costs) for politically powerful interest groups soon became the Post Office's primary function. Six groups gained financially from the Post Office: (1) coach contractors, (2) rail and steamboat companies, (3) postmasters, (4) publishers of printed matter, (5) officials with the franking privilege, and (6) rural voters. The rents extracted by those groups accounted for most of the money paid for postage. In what follows, I present rough estimates of the magnitude of the rents.

Coaches

Coach contractors were a very influential lobby in Washington. On the surface, horse, sulky and stagecoach contracts were determined competitively. Routes were auctioned off for four years. Allegations were made, however, that the bidding on contracts was rigged. Govern-

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ment treated postal contracts as an unofficial means of subsidizing transportation. Where enough business existed, a coach line could transport more cheaply than horse or sulky. In Great Britain, where coach transportation was not subsidized, the average coach contract cost 5¢ per mile compared with 5.2¢ for an average horse or mail cart contract although the coaches generally carried more mail (Select Committee on Postage 1837–38: XX(2), 251–52). In the United States, coach contracts cost more than horse and sulky contracts. In 1838 the average coach route cost 9.2¢ per mile while the average horse or sulky route cost 7.2¢.

When postage rates were lowered in 1845, the new law also did away with transportation subsidies. The Post Office was still given discretionary powers in determining the minimum amount of equipment necessary to carry out a given contract, but for the following two years the agency seems to have carried out the spirit of the law. The New England and New York contracts were renogotiated in 1845. The new contracts dropped the cost of horse, sulky, and coach transport by 45 percent per mile. The cost of coach transportation fell 49 percent from 7.3¢ per mile to 3.7¢ per mile. Lower-grade horse and sulky transportation fell 21 percent from 4.4¢ per mile to 3.5¢. Moreover, coach transportation, which had been used on 76 percent of the routes, was now used on only 49 percent of the routes (Post Office Department 1846). Extrapolating from those results, the Post Office predicted that $1 million could be saved by ending the transportation subsidy; that is, nearly half of what was being spent for horse, sulky, and coach transportation. The saving of $324,000 produced in the West the following year—somewhat more than predicted—confirmed the projection. There was some deterioration in service. The Postmaster General reported that deductions from the pay of contractors for failures and irregularities in 1846 totaled $26,273, which was significantly more than normal (Post Office Department 1847).

Railroads

The federal government had an unstated policy of subsidizing railroad and steamship companies. Railroads dramatically lowered transport costs for the private sector, but the construction of railroads actually raised the price of mail transportation. In 1838, Congress passed a law requiring the Post Office to make use of railways as long as their charge was no more than 25 percent above the charge of coaches offering similar service. Railroad companies further argued that coaches could not offer "similar service" because they were slower than trains. Some railroad companies, therefore, claimed that they

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were legally entitled to 25 percent more than a coach would charge if it could travel as quickly as a train (Post Office Department 1842). In 1843, the Post Office compiled statistics comparing the price paid for the first year of service on all existing rail lines and the last year of coach service on the line before the railroad took over. On average, railroads cost 87 percent more than the coach service they replaced. The increase in costs was highest in the South, where the price rose 181 percent.

Railroads were facing a private sector with elastic demand. Although hauling freight by wagon cost about 15¢ per ton/mile, railroads charged the private sector only about 5.5¢ per ton/mile (North 1973: 108). The government's demand was extremely inelastic. Officials believed they had a duty to transport mail by railroad or steamboat wherever possible to speed delivery. Otherwise, communications might fall into the hands of the private sector. The money that was spent simply came out of other groups' rents—groups that may have had less political pull than the railroad and steamboat companies.

To estimate how much this transportation cost, I use figures collected by the Post Office in 1843. In 1843, the Post Office spent $800,000 on rail and steam service. Government statistics show the Post Office transported 2 million paying letters and 4.3 million newspapers (including 160,000 pamphlets) in October of 1843. Letters weighed approximately .25 ounce and newspapers 2 ounces, so that the Post Office was transporting 284.4 tons of newspapers and paying letters that month. As explained later in this section, the Post Office also transported about 15 tons of franked material per month, so assuming October was typical, the Post Office was transporting a total of almost 300 tons of material each month. If one very generously assumes that the average pound of mail traveled 500 miles and half this distance was covered by railroad or steamboat,[1] the Post Office would have been paying the railroad and steamboat companies an average of 88¢ per ton/mile—16 times the common rate for freight. The postmaster general stated that mail was shipped no differently than freight (Post Office Department 1846). Route agents were on some important lines by 1837. They sorted mail and thus required additional space (Scheele 1970: 43). Even if one assumes that transporting mail cost 50 percent more than shipping freight, the real cost of transportation by rail and steam would have been only $74,500. Private express companies, which competed with the Post Office, paid nowhere near as much as the Post Office. For service between

[1]Fewer than 20 percent of paying letters traveled more than 400 miles. More than half traveled fewer than 150 miles (Post Office Department 1844).

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Washington and Cincinnati or Washington and St. Louis in 1849, express companies charged customers less than 4¢ per ton/mile (Senate Committee on the Post Office and Post Roads 1849–50: 7).

Patronage

In the 1840s, over 80 percent of the nonmilitary personnel working for the federal government were postmasters or postal clerks. The fact that each new administration caused heavy turnover in employees strongly suggests that service with the Post Office offered more than market wages. Postmasters were offered a proportion of the gross receipts at their post office and the ability to frank mail. In the case of small offices, the ability to frank was often worth more than the salary (*Congressional Globe* 1846–47: A21). In some cases, a businessman in town would use his political connections to gain the position of postmaster simply for the frank. Then he would turn over the work to an assistant who would work for the salary (House Committee on the Post Office and Post Roads 1843–44b: 9). Some postmasters made profits (political, social, or economic) by franking mail for acquaintances. Competition for the rents gained through a postmastership often was vigorous.

When postage rates were lowered, the deputy postmasters' commission was not changed. The amount they received per letter fell by more than half and they lost their franking privilege. Many of the deputy postmasters would not accept this cut and resigned. The postmaster general adopted temporary measures to raise pay. In 1847, Congress set up the new commission schedule. Under this schedule, payments to postmasters across the board dropped about 30 percent from the pre-1845 level. The Post Office had no problem finding men who would work for those rates. Postmasterships continued to be counted valuable spoils. Lincoln was accused of being more concerned with filling postmasterships than with prosecuting the Civil War (Fuller 1972: 292).

Printed Matter

Subsidizing newspapers was a government policy. It was publicly argued that the cheap transmission of public information was necessary to inform and educate voters. More cynically, the newspapers' influence on public opinion gave great political power and, thereby, encouraged the subsidy. Naturally, the public debate, which took place in newspapers, hardly questioned the desirability of low newspaper postage.

Before 1845, newspapers paid 1¢ postage for distances under 100 miles and 1.5¢ for distances over that amount. In addition, newspapers

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exchanged between printers went free.[2] The average newspaper cost 1.1¢ and weighed 2 ounces. Letters that weighed about one-eighth the average newspaper weight cost up to 16 times as much to mail. In 1843, more than twice as many newspapers were sent through the mail as were letters, and these were almost 97 percent of the paying mail by weight (Post Office Department 1844). Newspapers, however, paid less than 15 percent of the total postage ($536,547 out of $4,249,333). The Postmaster General informally estimated that newspapers had more than half their cost subsidized by letter mail (Post Office Department 1841). The First Assistant Postmaster General estimated in 1848 that the newspapers paid two-thirds of their cost (*New York Evening Post*, 26 December 1848). Any estimate of newspaper cost must be speculative. In view of the above figures, however, the First Assistant's estimate seems reasonably low—1.6¢. If newspapers had been required to pay their proportion by weight of just the transportation cost (not including the rents), newspaper postage would have averaged more than 2.25¢.

Franking

The most constant complaint in the press was the franking privilege of the government and particularly Congress. Because postage could be paid by the sender or receiver, mail was franked to and from Washington. Few could see the need for franking except members of government who described franking mail as an onerous duty. Addressing envelopes took a large chunk of time. As early as 1816, John Randolph described the House of Representatives as a "bookbinder's shop" (McMaster 1883–1914: IV, 360).

The frank was blamed for filling the mails with tons of useless speeches and other usually unread political material. Furthermore, those possessing the frank were often accused of abusing it for personal matters. Supporters back home would sometimes route their private correspondence through their congressional office. Members of Congress would accept and forward letters using the frank as a constituent service ("Post Office Reform and Uniform Postage" 1844).

Two attempts were made to estimate the amount of mail franked in the early 1840s. In October of 1843, records were kept indicating that 130,744 letters were franked by deputy postmasters, 18,558 were franked by members of Congress, and 85,339 were franked by other government officials. Congress was not in session during that month, so congressional franking was low. While Congress was in session

[2]Exchanging newspapers was the primary source of obtaining nonlocal news before wire services were created.

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during 1841, a three-week survey of the outgoing Washington, D.C., mail showed that members franked 20,363 letters and 392,268 documents (mainly speeches). Using the 1841 figure to estimate mailing within an average 33-week session, and the 1843 figure to estimate extra-sessional mailing, I estimate that members franked approximately 300,000 letters and 4.3 million documents per year. Deputy postmasters franked 1.5 million letters, and other government officials franked 1 million letters. Persons "well qualified to form an opinion on the subject" believed that half the mail by weight went free ("Post Office Reform and Uniform Postage" 1844). If one includes newspapers, that estimate is untrue. If, however, one is speaking solely of letters and documents, such estimates were fairly accurate. Assuming the average single-page letter weighed .25 ounce and October was a typical month for paying letters, the weight of that class of mail sent in 1843 was 190 tons. Government documents were estimated to weigh 1.25 ounces, so the weight of franked mail sent was approximately 180 tons.

Franked mail took as much effort sorting as regular letter mail. Sorting newspapers was much easier. If one assumes that a newspaper could be sorted at only a quarter of the cost of a letter, then the 7.15 million franked items accounted for $160,000 of the total $990,000 handling costs. Assuming the ton/miles of franks equaled that of letter mail, the cost of transporting franked mail by rail or steam would have been equal to the cost of transporting letter mail—$6,500. There is no good estimate of total transport costs for franked mail. Given the estimate that 2-ounce newspapers (with little handling cost) cost 1.6¢ each, the transport cost of the 1.25-ounce documents probably would have cost at least .5¢ each, for a total of $21,500. Total cost of franked material would, thus, be estimated at $188,000. The estimate is a bit low because there is no information on letters received by Congress.

Rural Voters

The subsidy of rural routes excited much controversy. Living in thinly populated areas entails higher transportation and communication costs. It is a common government policy to subsidize the higher rural costs. High-volume routes between the cities and large towns of the Northeast made sizable profits that were partially spent by politicians in creating and maintaining unprofitable low-volume routes for rural voters. Many, if not most, postal customers lived in rural areas, so monopoly rents distributed in this fashion helped offset the rents those customers were paying to other rent-seeking groups. Some rural customers may have collected more in rents than they paid out

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to other groups, but the real cost of service in even the most rural state was but 60 percent the postage raised within that state.

Rural subsidy became an important regional issue. In the North the relatively industrial states were profitable, while in the South all states but Louisiana lost money. In 1843, the Post Office was showing a profit of $372,892 in the relatively urbanized state of New York. This represented a profit ratio of 62 percent. Meanwhile gross revenues of $75,503 in North Carolina and $125,862 in Alabama covered only 50 percent and 58 percent of total expenditures respectively.[3] That phenomenon led Northern radicals to count high postage rates as another oppression perpetrated by the Southern slavocracy (*Cincinnati Weekly Herald*, 6 September 1843, 17 November 1843, 16 August 1844; and *Rochester Daily Democrat*, 16 July 1844).

There is no accurate way to determine by how much urban areas subsidized rural areas. The postal statistics collected for Congress do record the amount of subsidy the more urbanized states of the Northeast were providing the rest of the country. In 1843, the seaboard states from Massachusetts to Maryland earned a total revenue of $1.92 million. Expenditure in the region was only $1.28 million. Thus, 33 percent of what postal patrons paid in postage was a subsidy to the remaining states. The remaining states earned only $1.79 million, to offset just 74 percent of their expenditures of $2.42 million (Post Office Department 1847–48).

Totaling the Rents

The estimates I have made are rough. They suffice to show the general magnitude of the rents distributed, which is all that can be done given existing data. Evidence from the post-1845 cost reductions indicates that horse, sulky, and coach contractors received prices that were at least 90 percent above market prices as a subsidy. Railroad and steamboat companies received much greater subsidies. Even if one assumes that something special about mail caused it to cost 50 percent more than regular freight to ship, the companies would still have been exacting rents 1,000 percent over costs.

Finally, politically appointed deputy postmasters were receiving commissions 30 percent greater than those later found sufficient. Those figures assume that after reform (1) coach contractors and postmasters were no longer receiving sizable rents and (2) deterioration in service was insignificant. Table 1 shows that given those

[3]These Post Office figures count the rents extracted by the other rent-seeking groups as expenditures.

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TABLE 1

BREAKDOWN OF COSTS AND RENTS IN 1845[a]

Rent Seeker	Total Received	Costs	Rents
		All Mail	
Horse, sulky, and stage contractors	$2,025,000	$1,025,000	$1,000,000
Rail and steam contractors	881,000	80,000	801,000
Post office employees	1,414,000	990,000	424,000
Total	$4,320,000	$2,095,000	$2,225,000
		Letter Mail	
Horse, sulky, and stage contractors	$1,525,000	$ 525,000	$1,000,000
Rail and steam contractors	809,000	8,000	801,000
Post office employees	980,000	556,000	424,000
Newspaper publishers	259,000	–	259,000
Officials with frank	178,000	–	178,000
Total	$3,751,000	$1,089,000	$2,662,000

[a]The total received for all mail is taken from the 1845 report of the Postmaster General. The method for determining how much of the total is rent is that used in the text. Costs and rents for letter mail are figured using the following assumptions: (1) the average letter postage is 14.5¢, (2) the average newspaper postage is 1.1¢, (3) twice as many newspapers as letters are mailed, (4) newspapers can be handled for a quarter of the cost of either letters or franks, (5) each newspaper is subsidized .5¢, and (6) there are 7.3 million pieces of franked mail.

estimates, almost 59 percent of letter postage paid went as rents to the three groups.

The total effect of the subsidy of printed matter and franking was that the 25.9 million letters, weighing 190 tons and paying $3.76 million, had to support 59 million more items, weighing 3,407 tons and only paying $569,000. This situation amounted to at least a $437,000 subsidy, which was an additional 11.7 percent of letter postage.

Thus, more than 71 percent of the consumers' letter postage (including the rural voters) was being distributed as monopoly rents. Due

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to the subsidy paid rural states, monopoly rents were at least 81 percent of the postage paid in the seaboard states from New Hampshire to Maryland. Even in the remaining rural states, 61 percent of the postage paid was monopoly rent being distributed to one of the five groups (not including rural voters).[4] The rents the U.S. Post Office was distributing, relative to its size, were similar in magnitude to the profit the pre-1839 British postal service produced more openly. The fact that the Post Office was extracting the rents made it possible for smaller companies to compete successfully in mail delivery.

The Challenge to the Post Office

The Post Office had always faced informal competition. As steamboats and railways spread, the competition intensified. Very often, people with letters to send would go to the railroad station or the steamship dock. They would find a respectable-looking gentleman going the same place as the letters they wished to send and ask him to carry them. He would either drop them at the post office where they could be picked up for a penny apiece or else leave them at some other central location agreed upon where they could be picked up without cost (House Committee on the Post Office and Post Roads 1843–44c: 3; Post Office Reform and Uniform Postage 1844). In that way, there was no tax to pay, the sender bore the sorting cost himself, and there was no extra cost of sending a man with a non-optimal load. For the convenience of their customers, hotels and taverns would set out boxes in which letters for various cities could be deposited. The boxes would then be sent along with travelers ("New Rates of Postage" 1843: 510; *Rochester Daily Democrat*, 2 April 1844).

Informal mail service was also important for personal letters traveling between the East and the frontier. Long-distance postage was 25¢ per sheet and Midwestern farmers were often strapped for cash. Personal letters were kept until an acquaintance happened to be traveling the right direction and then entrusted to him (*New York Evening Post*, 25 November 1843).

Among businessmen in big cities a semiformal system developed in which any businessman sending an employee to another city would put up a sign notifying others who would bring over their mail. Large merchants could send mail almost daily between Boston and New York by those mutual agreements. The *New York Evening Post* (16 February 1843) reported: "Merchants of standing declare that of all the letters they receive from Boston, Albany and Philadelphia, four-

[4]This assumes that the proportion of costs to rents was constant across states.

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fifths come by private hand, free of expense, and not by mails or expresses."

Private mail contractors were legal as long as they did not compete with Post Office routes. The Post Office did not service areas that were too thinly populated. A writer in the *New York Evening Post* describes how his rural neighborhood had hired a contractor to pick up mail in the nearest town and deliver it weekly. In Wisconsin, the Post Office had refused a route to a still thinly populated area so a group of individuals agreed with the Post Office to manage the route themselves in return for the postage the route earned (*New York Evening Post*, 29 January 1844). In the western United States, it was common for express companies to open up mail routes to mining camps and isolated towns in advance of the Post Office (Scheele 1970: 30–31).

The U.S. Post Office began facing formal competition in 1839. A convenient rail and steamship route had recently been opened and William F. Harnden began a New York to Boston express. Harnden's enterprise proved a success and within months a number of other express companies, using primarily rail and steam routes, had opened in imitation. Business focused on the densely populated Northeast but quickly spread to major cities throughout the United States and Canada. Originally, the expresses specialized in transporting money and packages. That was legal. Soon, however, letters were being sent piggyback within packages of goods, and boxes of letters were being shipped between cities. The express companies themselves began to accept "packets" that were essentially equivalent to letters. Their service was cheaper and reputedly quicker and safer (*New York Evening Post*, 18 February 1843 and 2 October 1843). In November 1843, Adams and Co. were brought to court on the charge of transporting letters outside the mail. The law, being written before the age of steam, was aimed specifically at private foot and horse posts. In a controversial decision, the judge ruled that the law did not apply to rail and steamship posts (*New York Tribune*, 12 April 1844). This decision was immediately hailed as a triumph for free enterprise and later heralded as the beginning of "a new era in our Republic" (*Boston Evening Transcript*, 27 July 1844). Private mail companies began to be formed openly.

The most controversial business was the American Letter Mail Company, organized by Lysander Spooner. Spooner was not a businessman but a radical political reformer. He set up a mail service between New York, Boston, Philadelphia, and Baltimore partly to make money but mainly as a challenge to the constitutionality of the postal monopoly. The Articles of Confederation of 1778 had vested

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the Congress with the "sole and exclusive right [of] . . . establishing and regulating post offices" (Art. IX). The Constitution had simply granted "the power to establish post offices and post roads." This language led many, including Justice Joseph Story, to doubt whether the power the Constitution gave to set up posts and post roads was intended to be exclusive (Spooner 1971: I, 21; Priest 1975: 45–46). Spooner argued the postal monopoly was unconstitutional and in his newspaper advertisements he offered to cooperate with the government in bringing the issue in front of the Supreme Court if the government would leave his company unmolested until the issue was settled (*New York Tribune*, 20 January 1844). The Postmaster General was unwilling to cooperate, and Spooner was driven out of business after six or seven months due to fines, legal expenses, and the irregularity of his mail caused by government seizure (Spooner 1971, I: 14). Spooner also may have lost business to more efficient firms. While he riled the federal government with his "impudence" (House Committee on the Post Office and Post Roads 1843–44a), other mail companies—more intent on making a profit than making a point—kept a low profile and flourished.

The most successful private mail company was that of James W. Hale. Hale first worked for an express company on the Boston-New York route and formed his own post office about the same time as Spooner formed his. Hale, Spooner, and most other private mail carriers charged 6.25 cents per stamp or 20 stamps for $1.00. Unlike the Post Office, which did not use stamps, private companies required payment of the *sender*. Hale's area of delivery was New England and the Eastern Seaboard as far south as Baltimore. In January 1845, after a year in business, his company had grown to 84 post offices and had 260 employees (*Boston Evening Transcript*, 10 January 1845). This was still much smaller than the Post Office, which had 1,700 offices in New England alone. Many small imitators of Hale existed in the New England area. A contemporary visiting Boston in August 1844 reported: "All along Court street on both sides of State street, and almost cheek by jowl with the government post office, you see these private establishments for the transmission of letters and printed intelligence between the chief cities on the sea board, and from them to the principal towns far in the interior" (*New York Evening Post*, 3 September 1844). Mail companies sometimes cooperated. Small companies would maintain ties with big companies to enlarge the area of service (Bulkey 1978: 477–81).

Henry Wells, later of Wells Fargo, ran the most extensive service in upstate New York in company with Pomeroy and Livingston. In this area, letters to New York City had generally cost 25¢ per sheet.

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The new price of 5¢ generated great enthusiasm. Meetings were held in Lockport and other towns calling for a boycott of the Post Office until it quit harassing the private carriers and lowered its own rates to a competitive level (*New York Evening Post*, 8 August 1844). Henry Wells's company faced charges in the circuit court. The Post Office obtained convictions against Hale and Spooner in Pennsylvania and Maryland, but no jury in New York or New England would convict. Southern and Western cities were already served by express companies (*New York Evening Post*, 28 July 1843), but Wells's Letter Express Company was the first company specializing solely in letters to extend beyond the Northeast. For 10¢ per letter, it served the cities adjoining the Great Lakes as far as Duluth, Minnesota (Stimson 1851: 62–63; *Scott's 1992 Specialized Catalogue of United States Stamps* 1991: 283).

Rising competition stirred up calls for postage reform. State legislatures had been petitioning for postage reform as early as 1838. The postal reform movement became important after its first big New York City meeting in November 1843 (*New York Tribune*, 25 November 1843 and 27 November 1843). The reform movement among consumers, primarily businessmen, was strongly influenced by events in Britain.

The British postal service had ceased to grow after 1815. Private postal service had become widespread. In 1838, Rowland Hill caused a stir by proposing that the government adopt one low postage rate for all distances based on weight. He further proposed that postage be paid with the purchase of a stamp. Hill argued that the postal monopoly was not maximizing its profits. He argued that a drop in postal rates to a penny (2¢ American) would increase volume to such an extent that within a few years, profits would rise. His plan seemed to offer great benefits to consumers without serious harm to government profits. In 1839, British postage was cut to 2¢ for .5 ounce. The following year the volume of mail increased by 122 percent and then continued to rise. Costs increased only 13.5 percent the first year. The postal service remained profitable, but its gross receipts per capita did not regain their 1839 level for over a decade.

Post Office officials argued that postage could not be lowered in the United States because the population was much more dispersed than in Britain. The British postal service was cushioned by its large profits, but a fall in revenue in the United States would force a cutback in rents. The Post Office proclaimed that the first rent-seeking group cut would be the rural voters in the South and West. If that did not balance the budget, the shortfall would be made up by higher tariff rates. Such tactics won the Post Office strong support in many rural states. Consumer groups countered by pointing out that the prolifera-

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tion of private mail services already was causing a great drop in revenue. The government might have the legal power to shut down those services, but it was unwilling to face the political ire such an action would incur (House Committee on the Post Office and Post Roads 1843–44c: 5). The consumer groups welcomed such services but preferred a cheap universal government service. Reformers insisted that demand for postal service was elastic and promised that low postage rates would cause revenues to increase over the long run. Any immediate shortfall could be met by eliminating patronage and the frank (*New York Tribune*, 8 December 1843, 15 January 1844, and 6 December 1844).

In March 1845, Congress passed a law that lowered postage rates to 5¢ per .5 ounce under 500 miles and 10¢ per .5 ounce over 500 miles. Those were roughly the rates private companies charged. The law also closed loopholes to more effectively protect the government monopoly and tripled the fine for violations. The new system went into effect July 1, 1845. The express companies announced they would no longer handle letters (*Daily Picayune*, 8 July 1845). Most of the private mail companies seem to have gone out of business. Reports of continued private service included companies that delivered between large cities and the surrounding towns for 2¢ (*New York Evening Post*, 29 November 1845), a fast high-price letter express linking markets in New York City and New Orleans (*New York Evening Post*, 29 January 1845; Post Office Department 1846), and private routes in New Hampshire (House Committee on the Post Office and Post Roads 1847–48: 27).

One type of private mail company remained legal. That was the city dispatch or penny post. Post roads ran between cities, not within them, so private mails delivering intracity mail were legal. An earlier intracity post had been established in late 1839, but it did not deliver to and from the post office and soon failed (Abt 1949a). The first such successful American company was the City Despatch Post in New York City. This company was opened by Alexander M. Grieg in February 1842 and was purchased by the government after a few months in operation. In June 1844, John Boyd opened another private intracity delivery service. He began with twice-daily door-to-door deliveries and soon expanded to four. He collected from over 200 drop stations, gradually increasing the number to approximately 2,000. He undercut the City Despatch Post's price by a penny and soon drove them out of business. Boyd's intracity delivery service, along with that of D.O. Blood in Philadelphia, became a model for hundreds of similar services. In the late 1840s, a dozen services were competing for business in New York City alone. At this time, having a letter picked up and

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delivered cost only 2¢. Having a letter taken to or delivered from a post office cost a penny (Abt 1949b, Abt 1950).

Sometime during the late 1840s, express companies once again began delivering letters between major cities in the Northeast (Post Office Department 1849). They now provided the service for 2¢ per letter (*Congressional Globe* 1850–1851: 234–36). I found no details concerning this service. Earlier experience had taught private mail services to be very discreet. In spite of the renewed private service, Post Office revenues were increasing. Patronage, franking, and transportation subsidies had been trimmed. Congress was pleased with the increase in revenues brought about by the 1845 price cut and was worried private competition might once more begin to flourish. In 1851, therefore, Congress once more cut postage—this time to 3¢ per .5 ounce for any distance (except mail to and from the West Coast). The Post Office was given the right to declare city streets post roads. Almost all private intracity delivery was eliminated by 1860. The business established by Boyd in New York is possibly the only exception (Abt 1950: 371–80).

The Effects of Competition

The U.S. Post Office found the express and mail companies a serious threat. The Committee on Post Office and Post Roads reported in May of 1844:

> Events are in progress of fatal tendency to the Post Office Department and its decay has commenced. Unless arrested by vigorous legislation, it must soon cease to exist as a self-sustaining institution, and either be cast on the treasury for support, or suffered to decline from year to year, till the system has become impotent and useless [House Committee on the Post Office and Post Roads 1844: 2].

The pressure of competition from private firms was responsible for bringing about lower postage rates. It was also responsible for changing the nature of postal service. Private companies introduced payment-by-weight, prepayment, postage stamps, and home delivery to the American market. Those reforms were adopted afterward by the Post Office.

Private expresses bit into Post Office revenues almost immediately. Post Office revenues per person peaked in 1839 and continued to decrease until after the 1845 reform. Determining how much of the decrease was caused by private competition and how much was caused by the 1839–43 recession is not possible. From 1830 to 1839, Post Office revenue per person grew by 7.2 percent per year. By 1839, it reached 26.9¢ per capita. It fell to 21.3¢ in 1845 when government

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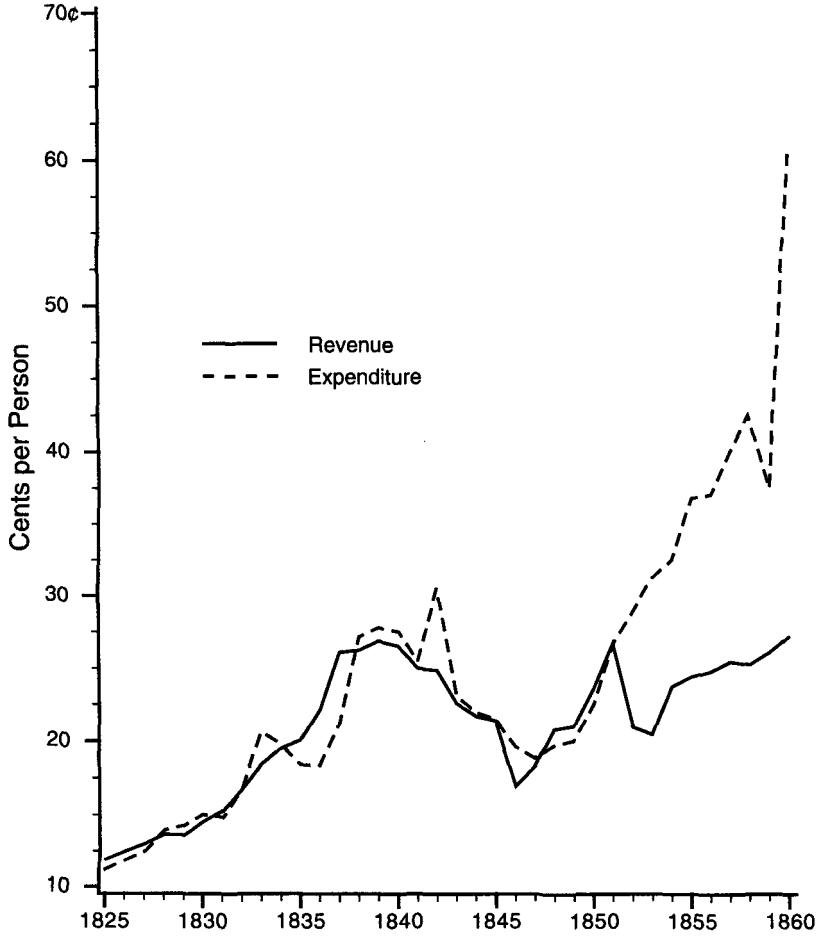
postage was finally lowered (see Figure 1). Unfortunately, there is no direct evidence as to the amount of mail delivered privately, so any estimate of the scale of private mail service must be speculative. If one assumes that overall postal services per person did not grow at all from 1839 to 1845, the figures would show that private enterprise had taken over 20 percent of the market as measured by revenue (at U.S. Post Office prices). If one assumes that the lower price of private mail stimulated the market for mail service so that it grew 5 percent per year, for example, then the figures would show that private enterprise had gained a much greater 40 percent market share. From 1839

FIGURE 1

REVENUE AND EXPENDITURE OF THE POST OFFICE, 1825–1860



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to 1844, revenue in all regions suffered. As shown in Table 2, revenue from the Gulf states fell farthest. Until the early 1840s, the Gulf states spent more money on postage per free individual than any other region. A high percentage of Gulf mail was to and from the Northeast. Before the advent of the express companies, the Post Office probably faced less informal competition on those long routes than on the shorter Eastern routes.

Private mails began to flourish toward the end of fiscal year 1844 and lasted through fiscal 1845. The drop in Post Office revenue per capita during that year centered in New York and included other Mid-Atlantic states and southern New England. Although the economy was strong in that year, New York State postal revenues dropped approximately 10 percent.

The lowering of postage rates in 1845 from an average of 14.5¢ to an average of 6.3¢ caused an immediate drop in revenue per capita of only 21 percent. Within three years the Post Office was running a surplus and within five years postal receipts per capita were back at the 1845 level. From 1846 to 1851, postage revenue per capita grew 9.7 percent per year. The short-term fall in revenues put the squeeze on those who were capturing rents from the postal system. Of them, only the newspapers gained. (Newspapers delivered less than 30 miles became postage free. That privilege was revoked in 1847.) Publishers had generally supported lower postage and had either convinced lawmakers that what was good policy for letters would also be good policy for printed matter, or else had simply impressed lawmakers with their political influence. Railroad and steamboat companies also managed to maintain their rents, as did rural voters. The groups that suffered were the stagecoach contractors, government officials outside of Congress, and deputy postmasters. As previously noted, reform meant an end to the official policy of subsidizing transportation. Such subsidies were not ended completely, but they were drastically scaled back in the Northeast and West and were trimmed elsewhere. The political power of the coach contractors seems to have been eclipsed by that of the railroads. Congress also ended franking privileges for all groups except themselves. Deputy postmasters were hit hard by the reform. They were paid by commission. Their earnings per letter declined with the cost of postage.

The second reform, in 1851, was not as evidently successful. In 1845, growth in postal revenues per capita had been in decline with little hope for reversal without major reform. In 1851, in spite of renewed complaints against private express companies, Post Office business was booming. The cut in rate to 3¢ for all letters again caused only a 21 percent drop in revenues. Revenue per capita returned to

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TABLE 2

REGIONAL DIFFERENCES IN POST OFFICE NET REVENUE PER FREE PERSON[a]

Year	Northern New England	Southern New England	New York	Middle States	Northern Interior	South Atlantic	Southern Gulf	Interior
1825	4.8¢	12.8¢	11.3¢	9.6¢	3.1¢	9.8¢	18.6¢	5.0¢
1835	9.8	23.1	20.7	15.9	8.6	16.7	35.6	11.4
1839	13.4	29.2	29.4	21.4	14.0	20.6	57.4	18.4
1841	12.8	28.7	29.0	19.9	11.7	19.7	36.9	15.9
1843	13.3	28.1	27.8	18.3	10.1	18.3	33.4	13.9
1845	13.0	26.2	22.7	17.0	10.6	17.2	33.8	13.4
1847	11.5	22.2	17.2	12.3	7.8	10.4	18.4	7.8
1849	13.5	26.8	23.0	14.8	9.3	12.4	22.4	9.4
1851	17.1	32.9	29.5	17.1	12.5	15.5	25.2	11.8

[a]Northern New England: Maine, New Hampshire, Vermont. Southern New England: Connecticut, Massachusetts, Rhode Island. Middle States: Delaware, Maryland, Pennsylvania, New Jersey. Northern Interior: Illinois, Indiana, Michigan, Ohio. South Atlantic: Georgia, North Carolina, South Carolina, Virginia. Southern Gulf: Alabama, Florida, Louisiana, Mississippi. Interior: Arkansas, Kentucky, Missouri, Tennessee.

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its 1851 level by 1860, and the price cut was hailed as a success. If the government's goal, however, was to maximize revenue or hidden profits, it is not evident that this price cut succeeded.

The price cut in 1845 showed that demand was least elastic in the South. Revenue fell much more sharply here than elsewhere (see Table 2). Overall, there appear to have been fewer substitutes for Post Office service in the South. The industrial states' subsidy of the more rural Southern routes became larger after 1845, but Southern politicians were unhappy with the cutback in transportation subsidies. Reformers realized that the quick growth of postal revenue made getting another reform bill through Congress much more difficult.

To sidestep opposition by rent-seeking groups, the law included a section directing the Postmaster General not to cut back services. Any shortfall in revenue was to be met by money from the general fund (House Committee on the Post Office and Post Roads 1847–48: 73). The new law broke down the firewall that had restricted rents and gave the rent-seeking groups access to the general revenue. Jefferson's fears proved true. Transportation expenditures, particularly in the South, rocketed. In 1845, opponents of postal reform had predicted that cheaper postage would mean throwing the support of the Post Office on the Treasury. The *Charleston Mercury* had prophesied that this change would destroy the Post Office's financial responsibility and that "in ten years you will have it cost you ten millions of dollars" (House Committee on the Post Office and Post Roads 1847–48: 26).

The prediction of the *Mercury* was made true after the 1851 reform. The Post Office's expense was $9.97 million in 1855. By 1860, postal expenditures of $19.2 million dwarfed the $8.5 million earned. East of the Mississippi, transportation costs per mile had risen from 5.9¢ in 1850 to 10.0¢ in 1860. The 1851 reform fundamentally changed the nature of the postal monopoly. Before 1851, the six rent-seeking groups drew their money from high postal prices that acted as a tax on letter writers. After 1851, the money was distributed through the Post Office but came largely from the general revenue. The great increase in subsidies the change entailed indicates that the political cost of redistributing money from the general revenue was significantly less than taking it directly from letter writers.

Besides driving down Post Office prices, private companies introduced a number of reforms that originated in Great Britain. Private mail companies first introduced to the United States the practice of charging mail by weight. This practice was imposed on the Post Office in 1845, although the Postmaster General remained uncomfortable with the new principle (Post Office Department 1846). An important aspect of the pay-by-weight plan adopted was that the generous

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.5-ounce allowance for single postage made the widespread use of envelopes possible. Another innovation was a simplified scale of postage. Hill had pointed out that the cost of transporting mail in bulk over large distances was extremely low so charging by distance was not cost effective (Coase 1939). Great Britain, therefore, adopted a flat 2¢ rate. Private mail companies in the United States began with a flat rate and moved to a two-tier system. In 1845, the Post Office began imitating that system and in 1851 adopted a flat rate.

The simpler rate system combined with prepayment led directly to the use of stamps. Prepayment had been optional and little used in the United States. Complaints of letters not reaching their destination were common and payment on delivery was an incentive to better service. Private mail companies insisted on prepayment. They thus lowered handling costs by using stamps and avoided the loss due to unclaimed letters. Customers accepted prepayment in a competitive system. If the company failed to deliver, the recourse was to give someone else one's business. After 1847, the Post Office began to use stamps, but stamps did not become standard until 1856—one year after prepayment was made obligatory.

Finally, private mail companies began home and office deliveries. In the United States, government letter carriers delivered out-of-town mail in the largest cities for 2¢ per letter, but the first intracity mail services were private. Private intercity mail companies made a practice of delivering door-to-door free within the towns and cities they served. Private mail companies could not afford small rural post offices, so to extend their coverage they offered to deliver to any residence within 30 miles of one of their post offices for an extra 5¢ (*Rochester Daily Democrat*, 13 August 1844). Between 1851 and 1860, the Post Office gradually took over the intracity business in the most populous centers. Door-to-door delivery was eventually made free and extended to large towns. The Post Office did not imitate the rural service of the private companies. Rural delivery was not attempted until the turn of the century, when it was finally offered as a free service.

Conclusion

In the first half of the 19th century, the federal government's legal monopoly over the mail was a monopoly over all intercity communication. Informal and illegal channels of communication had always existed, but their inconvenience and limited scope allowed the Post Office to earn huge monopoly profits. The government's policy of running the Post Office on a "nonprofit" basis simply channeled the rents (profits) to powerful political groups who were in a position to

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draw directly from the Post Office coffers. Those profits gathered from the U.S. Post Office were of the same magnitude as the profits earned more openly by the British postal service.

The transportation revolution lowered the cost of intercity transportation and communication in the 1830s and 1840s. Private companies met the change by offering low-cost transportation and communication. The Post Office, facing no formal competition, at first kept its prices fixed. As costs dropped, monopoly profits increased. The profits became large enough to draw competitors despite the legal risk. That competition, and pressure from consumer groups, caused the Post Office to lower its rates in 1845 and 1851 by 79 percent.

The effect of private competition went beyond the drop in postage rates. An equally important effect was the introduction of new techniques into the U.S. market. The most important innovations were prepayment with stamps and intracity pickup and delivery. The Post Office showed no sign of adopting such innovations until they were successfully used by private companies.

A private postal system was probably not a realistic possibility. Privatization would have led to an 80 percent cut in federal civilian employees and the loss of thousands of lucrative transportation contracts. Some rural areas may have faced higher postage prices, and politicians played that threat to the hilt. If rent-seeking groups could have been bought off with side payments, private companies might possibly have made communications in the United States more efficient; such side payments were never attempted.

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Order Out of Anarchy: The International Law of War

Gary M. Anderson and Adam Gifford Jr.

War is often assumed to be the paradigm of anarchy, the Hobbesian state of nature in practice. War, in that view, is merely the predictable violent breakdown of law and order that follows from the lack of a world government.

However, that view ignores an interesting and important aspect of the "anarchic" international order. A complex system of norms, including both cultural and legal institutions, exists and functions to constrain warfare. In fact, the idea that the conduct of armed conflict is governed by rules appears to have been found in almost all societies, without geographical limitation (Roberts and Guelff 1982: 2).[1] These rules do not work perfectly. But they clearly restrain the behavior of nations at war, at the margin.

The use of violence to transfer resources from one party to another—the central feature of war—is an externality. Because warfare destroys resources in the process of transferring them, it is also a negative-sum game. Historically, the purpose of the constraints on war was not to eliminate the basic externality resulting from the coercive transfer itself but, more modestly, to make the sum of the game less negative. The resources destroyed during war can be thought of as the transactions costs of war. The cultural and other constraints on war, including what we now call the laws of war, then, reduce the

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[1]Such has been the case since ancient times. For example, during the Egyptian and Sumerian wars of the second millennium B.C., the combatants observed formal rules limiting acceptable behavior during warfare (Friedman 1972: 4). The Greeks and Romans observed a multitude of limitations on combat, and during the Middle Ages, "a law of arms was developed in Europe to govern discipline within armies as well as to regulate the conduct of hostilities" (Roberts and Guelff 1982: 3). Those early rules and limitations reflected the same basic principles found in modern laws of war.

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transactions costs. If the constraints worked perfectly, war would become a zero-sum game.

The value of the resources destroyed in war (the transactions costs of the conflict) are a result of externalities caused by decisions made by individuals. Like all externalities, the decisions involve a divergence between private and social costs and benefits borne by the decision-maker. The various formal and informal constraints on the practice of warfare function as a kind of constitution that reduces the various externalities. World society stands to benefit from any mechanisms, formal or informal, voluntary or enforced, that mitigate (if not actually eliminate) the transactions costs associated with violent quarrels between nations.

The "international constitution" reflects the expression of a spontaneous order on the international scene, a product of human action but not of human design, comparable in many ways to the U.S. Constitution, at least in its basic functioning. Our intention here is to explore this international constitution.

The International Laws of War

The international scene is characterized by anarchy, in the literal sense: there is no "world government" capable of exerting its will via coercion on competing nation-states. However, the "anarchic" community of nations is not lawless. There is, in fact, an elaborate and well-developed body of international law that functions, in theory, to constrain the misbehavior of actual and potential combatants.

F.A. Hayek (1973) argues that the common law is a kind of "spontaneous order," a body of rules that have evolved over time without being designed by governmental authorities. For example, Bruce Benson (1989) shows that modern commercial law has largely grown out of efforts undertaken by the merchant community to resolve recurring disputes. It has not been provided by governmental fiat. The laws of war constitute a variation on this theme: they are rules that have evolved to resolve practical problems confronting the relevant actors (who happen to be national governments) relating to military conflict, and that have not been legislated by an overarching, central authority.

The laws of war have two basic sources: customs and treaties or conventions. Customary law comes down to us from ancient practices and from case-by-case development, much like English and American common law. Treaties and conventional laws are the result of international agreements, conferences, and conventions. Before the mid-1800s, bilateral treaties represented the only source of law aside from customary law. Conventional law, which did not develop until the

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second half of the 19th century, is the outgrowth of international conferences such as those at The Hague (Netherlands) and in Geneva (Switzerland). Many of the early conferences took up the task of codifying customary law. As a result, much of the early customary law is also part of the conventional codes.

The principal aim of the laws of war is to specify the rights and obligations of belligerents and the rights of neutrals and noncombatants. Traditionally, civilian noncombatants were not legitimate targets of force. They, along with those in the newly noncombatant ranks (including prisoners of war), were to be treated humanely. Neutrals had the right to trade during time of war, including the right to trade with a belligerent, subject to certain restrictions. The legal right of neutrals to engage in trade with the enemy has led to a host of disputes in international law and has been the subject of many revisions.

The laws of war place constraints on the actions of a belligerent in that the type and severity of force a belligerent can use to harm an enemy is not unlimited. The constraints are based on the basic principles of military necessity and humanity.

The principles of necessity and humanity require the use of force to be limited so that military goals are achieved with the least possible destruction and expenditure of human and other resources (Allison 1968: 16–17). One of the reasons the laws of war are observed is that it is generally in the self-interest of decisionmakers to achieve military objectives at the lowest possible cost.

In the modern world, most law is provided by government. In the case of international law, while the body of rules is a result of interactions among governments, the law per se is not governmentally provided. International law, then, is a nongovernmentally provided public good.

Several factors induce states and their armed forces to comply with international law, short of coercive mechanisms of enforcement; it is not always necessary to hire police to ensure civil order. The factors include the desire to be perceived as acting in accord with internationally perceived norms; the hope that the enemy will comply with the norms as well; the loss of friends and allies that may result from war crimes, as well as the consideration of neutrals becoming enemies. Those considerations can be termed "soft" factors, in that they are inherently difficult to objectify, however significant they might be in certain cases. Similar considerations play a role in motivating civil behavior among individuals in society, as social theorists since David Hume and Adam Smith have noted.

All those factors depend on the incentive of nations to maintain the value of their reputational capital by acting in accordance with

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standards of international civility. Nations, in other words, will tend to do a better job of behaving themselves when their long-run international interests are affected significantly by their reputations as honorable and reliable partners, in the eyes of the world. As Adam Smith ([1763] 1896: 253–54) noted in the slightly different context of the choice by individuals in society to behave honorably and reliably, "A dealer is afraid of losing his character, and is scrupulous in observing every engagement." Maintaining smooth relations with actual and potential trading partners is a valuable investment in its own right. Both individuals and nations have an incentive to obey the law for fear that their respective businesses will suffer.

Commerce encourages a kind of "self-policing" of moral behavior, but all modern societies also provide themselves with actual police as a kind of supplement to the incentive effects at the individual level rewarding civil behavior. Similarly, international relations are not rendered entirely honorable and civil by the functioning of economic incentives for good behavior.

At the individual level we need to factor in the deterrent effect of formal law enforcement mechanisms: that is, the police. But the international environment in which different nations interact is characterized by anarchy, in the sense that there is no overarching, supreme world government to act as law enforcer. There was and is, of course, no central authority or court that can be used to bring malefactors to justice. The World Court, which might fill this role, relies on the voluntary submission of parties to its rulings and even on the voluntary submission of parties to appear before the Court.

Fortunately for civilized society, informal enforcement mechanisms exist that strongly discourage opportunistic behavior on the part of particular national governments. The international constitution is defended, and deviations from the requirements of international law are sanctioned, by the informal mechanisms. Along the way, a (mostly) smoothly functioning, efficient international order of competing nation-states emerges despite the absence of an international monopoly of coercion. One result is that the world economy functions effectively even under conditions of international anarchy.

Constraints on the Behavior of Nations at War

The primary reason order emerges from anarchy in this case is that the laws of war are partly self-enforcing—that is, they work because it is in the interest of the belligerents to obey the rules of conduct. Two sources of self-enforcement concern reprisals and annexation.

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Reprisals

When nations go to war, an important constraint on their behavior is the likelihood that the enemy will retaliate for unlawful behavior. This threat of reprisal helps to deter the use of weapons and tactics in violation of international law.

Reprisal is important in both a formal and a tacit form. Formally, the international law of war provides legitimate grounds for applying force by one state against another state in proportionate retaliation for a defined violation (see De Lupis 1987: 74–75). But beyond the limits of formal law, the threat of retaliation functions as a restraint against misbehavior.

The process by which the threat of reciprocal reprisal works is sometimes termed "tit for tat" (see Axelrod 1984). Threatened retaliation tends to be roughly proportional to the initiating act of misbehavior. Robert Axelrod argues that tit for tat constitutes a robust and efficient strategy in bilateral games and that the strategy dominates in the long run because it works so well. The restraint on misbehavior functions tacitly, independent of formal enforcement mechanisms.

Annexation

Throughout history, although wars have been fought for a variety of reasons, a primary motivation behind warfare has been the potential gains associated with the conquest of foreign territory as well as the appropriation of other wealth in the enemy country. Military victory has often resulted in the surrender by defeated nations of portions of their sovereign territory. As recently as World War I, the victorious Allied powers received billions of dollars in payment from the defeated Central powers. Although this transfer was termed "war reparations," rather than "tribute," and theoretically represented compensation for war-related damage imposed by German actions, the transfer was similar in principle to those that had been demanded by victors in war for thousands of years.[2]

To the extent that wars are fought by states seeking to maximize their net revenues, governments are encouraged to minimize the costs of war to the economies of those nations involved. The value of potential conquests is reduced by damage produced during wartime. Thus, states have an economic incentive to minimize the extent to which their military efforts produce collateral damage on their enemies.

[2]The post-World War I German reparations scheme was, of course, complex, and included features designed to impede the ability of German exports to compete effectively with domestic producers in Allied nations (see Trachtenberg 1980: 3). But that simply means that the recipient governments took some reparations payments in forms other than cash.

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The potential for possible appropriation through conquest of foreign-owned resources has two different effects. First, would-be conquerors have an incentive to preserve the economic value of annexed territories and people. This factor tends to reduce the extent of collateral damage caused by foreign invasion, other things held equal; conquered territory would become friendly territory, and conquered people were future citizens and taxpayers of the conqueror.

Of course, restraint sometimes interferes with military efficiency. Preserving the value of annexable enemy property may interfere with the goal of defeating that enemy's war effort. For example, the aerial bombardment of enemy munitions factories might significantly reduce the enemy's ability to resist conquest, despite the fact that such a bombing campaign would tend to reduce the value of that enemy's resource base available for conquest. Therefore, damage to the civilian economy of the enemy tends to be minimized by a prospective conqueror, although collateral damage still occurs.

Thus, informal enforcement mechanisms (in the form of economic incentives for good behavior) play an important role in maintaining international order. Those incentives tend to minimize, other things held equal, the destructiveness (and economic wastefulness) associated with violent conflict between states.

The underlying structure of international law that reflects the requirements for an efficient international order is itself determined in a process of competitive cooperation, in which various participating international players formally agree about which rules to follow, in what way. The requirements are themselves influenced by the course of technological change. Obviously, generally accepted rules of international law restricting the practice of area bombing would have been irrelevant before the invention of the airplane. Throughout history, the evolution of the international constitution has been affected repeatedly by these changing technological constraints.

Technology and War

Technological change has had a profound influence on the waging of war. The invention of the composite bow, the chariot, and gunpowder all significantly altered the nature of warfare. Starting in the 16th century, widespread use of guns in religious and political wars led to high casualty rates not seen in medieval wars.[3]

[3]The destructiveness of the Thirty Years War, during which as much as one-third of the German civilian population was killed, is widely considered the starting point of the modern study of those laws (Roberts and Guelff 1982: 2; Friedman 1972: 14).

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Significantly, many new technologies that had an impact on war were not specifically designed for military purposes and many, such as paper and the clock, seem far removed from the battlefield. Those particular innovations improved the coordination of troop movements over vastly larger areas than was possible before their introduction.

The technological advances and the imperatives of total war blurred the traditional distinction between combatant and noncombatant and placed great stress on the established rules of war. If the international laws of war are to persist as meaningful constraints, they must be adapted when confronted with changes in technology or other external forces that would render them inefficient. Further, the laws of war cannot stop the introduction of new militarily efficient weapons, but rather must be modified to insure the use of new weapons is consistent with the goals of international law. Both world wars saw the introduction of weapons that placed extreme stress on existing rules (e.g., strategic airpower). In response, new rules often were adopted that maintained the objectives of the law to as great an extent as possible given the new circumstances.

Thus, the inherited doctrines may be adapted to the needs of legal control in an era of rapidly changing technology—much like Anglo-American common law.

The Case of Naval Warfare

A primary objective of war at sea is the disruption and destruction of the enemy's commerce and the protection of one's own. Historically, disruption of an enemy's trade was accomplished by blockading its ports and by capturing, or if capture was infeasible, destroying its commerce on the high seas. The technological advances of the Industrial Revolution had a profound effect on the way those activities would in the future be undertaken.

Under international law a commerce raider—whether a commissioned naval vessel or a commissioned privateer—was required to "visit and search" before a prize could be taken or sunk.[4] Only if the ship was an enemy ship, or its cargo contraband intended for the enemy, and only if its crew and passengers left in a position of safety, could the ship or cargo be taken or the ship sunk.

Traditionally the laws of war stipulated that a blockade of enemy ports must be a close-in blockade conducted by ships slowly cruising

[4]The Declaration of Paris of 1856 abolished the taking of prizes at sea by privateers and, aside from an aborted attempt by the South in the Civil War, effectively marked the end of this practice. Visit and search required that a vessel be boarded and its papers and cargo inspected and its crew and passengers removed to a place of safety (which did not include abandoning them in lifeboats on the high seas). See Anderson and Gifford (1991).

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off the enemy port. Further, before the 19th century international law limited enforcement to certain goods (contraband) that were directly used in the waging of war, such as arms, gunpowder, and naval stores. Neutrals were allowed to trade noncontraband goods with belligerents. The use of the submarine as a commerce raider made visit and search impractical, and submarines, mines, and airplanes rendered impractical the close-in blockade.

Although the submarine eventually became the primary commerce raider, commerce raiding was not its intended military use at the outset. Originally, submarines and surface torpedo boats were envisioned as simple adjuncts to surface fleets. Second, it was recognized that use of the submarine was incompatible with the requirement of visit and search. In this case technology and practicality led to a change in the formal rules of war.

With the outbreak of World War I Britain set up a long-distance blockade between Scotland and Norway, in violation of the traditional requirement that blockades be close in. The traditional close-in blockade was of course made impossible by submarines, contact mines, and other new technologies. Britain also extended the contraband list to virtually everything, thus engaging in an illegal "starvation blockade." The relative ineffectiveness of the submarine against military targets led Germany to use the submarine in its most effective occupation: that of a commerce raider.[5] Justifying their action as a legal reprisal against the allegedly illegal British blockade, the Germans began an unrestricted submarine warfare campaign against British merchant ships in February 1915.

Although the Germans evidently intended that only enemy ships be subject to this unrestricted warfare, difficulties in identifying enemy ships and the British purchase of neutral flags for their merchant ships led the Germans to sink neutral shipping in an operational area of war in the waters surrounding Great Britain and Ireland.

The British declared operational areas during both wars in the North Sea between Scotland and Norway to isolate German warships and interdict German shipping. Those operational areas were, in essence, long-distance blockades, substitutes for impractical close-in blockades. The Germans extended their operational areas during World War II to the Atlantic and Mediterranean, and announced that they would sink enemy shipping without warning.[6]

[5]German submarines sank the British armored cruisers *Cressy*, *Houge*, and *Aboukir* in September 1914 and the battleship *Formidable* in January 1915, actions that occurred in waters close to British ports in the North Sea and the English Channel, where the concentration of British war ships was high (Keegan 1988: 253). On the high seas the submarine's slow speed rendered it of limited effectiveness against naval vessels.

[6]The United States proclaimed a similar operational area in the Pacific during World II.

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Because of the vulnerability of submarines to even light arms, the traditional visit and search of a merchant vessel was extremely risky for a submarine, and made even more so by the British practice of arming their merchant ships. Under the traditional laws of war only legitimate combatants, that is, commissioned naval vessels and privateers, could be armed. That rule helped assure the safety of noncombatants on merchant ships because belligerents were less likely to use force when they could remove seamen and passengers to places of safety without fear that they would be attacked by the merchant vessel. The arming of merchant vessels was itself illegal and could be used by Germany to justify sinking without warning as a legal reprisal.

Germany discontinued the campaign of unlimited warfare against merchant ships on May 4, 1916, not because it could not be justified under international law, but rather to avoid provoking the United States into entering the war (Mallison 1988: 64).[7]

Between the wars several attempts were made to limit or prohibit the use of submarines in war.[8] During the Washington Conference of 1921 and 1922 the British failed in an attempt to achieve a total abolition of the use of the submarine in war. A naval conference in Geneva (1927) also failed to restrict the use of the submarine in warfare. By the beginning of World War II, however, all major nations had agreed that the traditional rules regarding visit and search applied to submarines[9] (see Friedman 1972; Mallison 1968; and Roberts and Guelff 1982).

[7]On February 1, 1917, Germany resumed unrestricted use of submarines against belligerents and neutrals alike in a war zone around Britain, France, and Italy and in the eastern Mediterranean. Germany justified this action as a legitimate reprisal against alleged British violations of international law, which included arming of merchant ships and instructing them to open fire on German submarines, using Q-ships, and maintaining a long-distance hunger blockade. Q-ships were vessels that "appeared to be innocent merchantmen but were actually heavily armed warships. . . [whose] function was to lure German submarines to the surface and to destruction. . .when the submarine attempted to carry out the time-honored procedures of visit and search" (Mallison 1988: 5).

[8]An attempt was made before World War I to prohibit the use of the submarine in naval warfare. The 1899 Hague Conventions (Hague IV, 2 and 3) failed in their attempt to reach a general arms limitation agreement, though they did limit the use of projectiles whose purpose is to disperse asphyxiating gases, the launching of projectiles from balloons, and the use of expanding bullets (see Friedman 1972: 247–50).

[9]Part IV of the Treaty of London (1930) affirmed that submarines must "conform to the rules of International Law to which surface vessels are subject," that is, they must engage in visit and search and merchant vessels could not be sunk without warning if they were unescorted, but they could be sunk without warning if they were escorted. The Proces-Verbal of London 1936 was an attempt to expand the number of states accepting the limitations of the 1930 Treaty, and by the outset of World War II 50 nations had agreed to abide by the limitations, including all the major participants in that war.

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Technological Change and Transactions Costs

Another economic factor affecting the misbehavior of combatants in war relates to the transactions costs associated with combat. For example, atomic weapons permitted a vast increase in the effectiveness of strategic bombers during war, at a cost of high potential collateral damage to the civilian economy. Nuclear war would increase the cost of the military transaction, while simultaneously improving the technical efficiency of war fighting on both sides.

Clearly, the relationship between the growth in military technology and the level of associated transactions costs in war is not simple or unidirectional. Advances in the ability of nations to militarily vanquish opponents are not necessarily indicative of a lower relative price for minimizing collateral damage. The World War II strategic bombing campaign and commerce raiding by submarines in both wars seem clear examples of a positive relationship (in the short run) between the risk to enemy noncombatants and the advance of technology. The atomic bomb would obviously constitute another example.

However, as a rule advances in military technology have tended to reduce this price over the long run and consequently lower the destructiveness of war to civilians. Witness the effect of the radical improvements in bombing accuracy between World War II and the 1991 Iraq War on civilian casualties in the two cases (see Dunnigan and Bay 1992). With the advent of the submarine and change in the nature of war since the Industrial Revolution, the law of war relating to merchant shipping adapted to the new technology, changing from a rule requiring visit and search to one allowing the sinking without warning of merchant vessels.

The laws of war do not restrict the introduction of more efficient weapons. When a technical change occurs (like the invention of the submarine) that renders the existing rules untenable, those rules tend to change in response. Following two world wars during which visit and search proved unworkable, the rule was abandoned as part of the international laws of war. Under the new rules merchant seamen and merchant ships were given combatant status, which meant that they could offer armed resistance to enemy warships, but which also potentially subjected them to attack without warning.

Under the new rules merchant ships were subject to attack without warning and duties to survivors were greatly diminished, submarines were not required to ensure the safety of the crew and passengers of vessels that they sank.[10]

[10]As a result of the tight confines of submarines there was no room for survivors of torpedoed enemy merchant ships (Mallison 1988: 11).

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The new rules maintained the vital prohibition against killing survivors. Both German and Japanese officers were convicted at war crimes trials in Nuremberg and Tokyo, respectively, of deliberate actions resulting in the death of survivors of submarine attacks (see Piccigallo 1979; Woetzel 1960). Further, neutral shipping engaged in trade outside of operational areas with other neutrals was still protected from sinking without warning. New technology also made the traditional close-in blockade untenable, and the maintenance of operational zones on the high seas was accepted under international law as a rational adjustment to the new circumstances.

International Law and the Technology of Strategic Bombing

The reputation of a nation's government as a responsible international actor can conflict with that same nation's reputation as a formidable opponent. Acquiring a reputation for ruthlessness in war may benefit a government by deterring potential future opponents from challenging that regime on the battlefield.

Further, international law tends to lag behind the growth of military technology. The invention of the modern submarine represented one such episode. Another example is the Allied strategic bombing campaign during World War II.

The 100 largest German cities were heavily damaged during the Allied strategic bombing campaign, which resulted in the deaths of approximately 570,000 German civilians. All but the smallest Japanese cities were subject to massive incendiary bombardment, and those raids killed between 500,000 and 900,000 Japanese, counting those who perished at Hiroshima and Nagasaki (Ellis 1990: 526–27). There has been considerable controversy since the end of World War II over the morality of that deliberate policy, as well as debate about the military usefulness of area bombing of civilian targets. The legality of the strategy, however, is fairly clear: strategic bombing of enemy cities and their civilian inhabitants did not constitute a violation of the international laws of war. Not until Protocol I of 1977 was area bombing technically prohibited. The Protocol prohibits indiscriminate attacks, and area bombing is one of the principal forms of indiscriminate attack (De Lupis 1987: 240–41).

Basically, there was no body of law regarding the conduct of strategic bombing before or during World War II.[11] The nearest equivalent to

[11]A draft proposal for rules was circulated in 1923, but did not receive approval from the signatories of the Hague Convention and therefore never achieved legal status.

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rules applicable to the strategic bombing question was Section IX of the Hague Convention of 1907, which defined the rules applicable to naval bombardment. Those rules permitted the legal bombardment of workshops or plants useful to the enemy war effort, allowed the bombardment of defended locations, and even permitted the bombardment of undefended locations if the local authorities did not agree to remove all facilities of military usefulness.

Simply stated, German and Japanese cities—and their inhabitants—were legal and legitimate targets under existing international law because they contained production facilities of use to the enemy war effort (e.g., munitions, but also steel foundries, pharmaceutical industries, and the huge variety of other "nonmilitary" facilities useful in modern war), and also because the enemy governments defended those locations. Allied bombers confronted not only enemy fighters defending strategic targets, but also ground-based antiaircraft fire ("flak"). Although Axis defensive measures became increasingly weakened, Allied bombers continued to take losses to enemy fire until the end of the war (see Ellis 1990: 196–200).

Since World War II, the international law of war has gradually evolved a set of detailed rules dealing with the problem of aerial bombardment of cities. As written, the restrictions forbid the area bombardment of enemy cities as practiced during that World War II. However, the new rules date only from 1978 and have yet to be tested in court.[12]

Even in the absence of legal restraints on the wartime use of a given form of military technology, other factors may influence the willingness of a belligerent to impose collateral damage on the economies and civilians of enemy and neutral nations. A rational government will calculate the costs and benefits associated with particular military strategies, and select the combination of friendly losses and enemy civilian damage that maximizes the net return from the enterprise of war. Nonlegal, economic constraints affect the willingness of warring nations to impose damage on the lives and property of noncombatants.

Conclusion

War is usually represented as the paradigmatic case of anarchy: a chaos of conflict, butchery unrestrained by law. But for all the waste

[12]One rationalization for the use of area bombing during World War II involved the technical limitations of available bombing equipment. Existing bombs, bombers, and bombsights were extremely inaccurate, making precise attacks on particular targets of military importance (e.g., a munitions factory) practically impossible. Modern "smart" bombs and precision-guided ordnance have eliminated the basis for that justification of area bombing. Of course, the use of such precision-bombing techniques is beyond the military capabilities

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and cruelty caused by war, in the modern world war is not unrestrained by law. An elaborate international law of war has developed, which together with various economic constraints functions to limit the destruction war causes. The structure of international law has emerged as a byproduct of the competitive interactions between different national states, each pursuing its own distinct goals.

National governments are not monolithic entities, and public policy in general is the result of competing pressures in the political marketplace. But international relations are, indeed, a world of anarchy. There is no world government to impose rules on competing nation-states. Yet rules exist, and the conduct of warfare generally follows recognized limits. That simple fact offers powerful evidence that a body of law can emerge even though a government is not available to impose it.

We do not claim that the law of war is perfect, or that the waste and destructiveness of war has been abolished by the acceptance of international convention. The international community is a kind of market, and in the real world, markets are not perfect. As we have noted, the law of war has often lagged behind the reality of new technologies; yet the law does change to accommodate those new realities. Also, it is difficult to distinguish between the effects of economic incentives and those resulting from international agreements as constraints on military action. In the end, however, the law of war not only exists but limits the destructiveness of war.

Despite the regime of anarchy at the international level, the actors in the international community are national governments, and a relevant imperfection in the effectiveness of waste-minimizing international agreements may result from the influence of bureaucratic imperialism. The bureaucracies devised by governments to implement policy tend to develop their own independent economic interests that conflict with the policy goals of the political decisionmakers. The relation between those in political power and their bureaucratic employees may break down, particularly during wartime. For example, the bureaucracies of armies may sometimes benefit from longer (and more destructive) wars than would maximize the interests of the nations they serve.

In the end, like other instances of spontaneous order, the law of war is not capable of producing perfect peace and harmony. Yet, it makes a vital contribution to the prosperity of civilization.

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of the forces of many countries, as the recent history of the conflicts in Bosnia and Chechnya suggests.

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A Rule to Stabilize the Price Level

Kevin Dowd

The available evidence suggests that the costs of inflation are very large and the benefits are relatively small.[1] A strong case therefore exists that central banks should make the elimination of inflation and the subsequent maintenance of price-level stability their overriding objective.[2] However, the maintenance of price stability is not an easy technical matter, and if a central bank were to commit itself to price stability, it must have a clear idea of how it would intend to achieve that goal. The question therefore arises: What is the technically most efficient means to achieve price stability? Should the central bank implement a monetary target along conventional monetarist lines? Should it go back to some version of the gold standard? Or is there some other rule it should adopt?

This paper considers the main options facing a central bank and assesses their pros and cons. The most popular solution among modern economists is for the central bank to target the money supply and be left considerable discretion over how it should achieve that target. For a variety of reasons, however, it is an extremely difficult matter in practice to hit money supply targets with any reasonable degree of accuracy, and even successful money supply targeting can still fail to deliver the ultimate objective of a stable price level if velocity is unstable or the economy is hit by shocks or undergoes too much transformation. The alternative favored by older generations of economists was a gold standard. The gold standard is much easier to operate, but the price level under the gold standard is vulnerable to whatever

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[1]See, e.g., Cozier and Selody (1991), Dowd (1994b), Howitt (1990), and Selody (1990).

[2]For recent statements of this position, see Angell (1990), Gavin and Stockman (1988), Hoskins (1992), and Jordan (1992).

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factors influence the supply and demand for gold, and it is therefore unlikely that the gold standard would deliver the degree of price stability we would want.

The problem with the gold standard has long been recognized, and a solution suggested long ago by Alfred Marshall, symmetallism, was to replace gold with a basket of precious metals. The presumption underlying the symmetallic standard was that the price level would be more stable than it would be under the gold standard because shocks to the individual relative prices of the included commodities would to some extent offset each other. Marshall had in mind a basket consisting of gold and silver only, but the basic principle can be extended to a basket covering many different goods. If individual relative price risks to some extent cancel out, then the larger the basket, the more stable we might expect its relative price, and hence the price level, to be. Taking this principle to its limit, our ideal basket would be a very broad one that covered virtually all the goods and services traded in the economy.

But the larger the basket, the greater the handling, storage costs and other costs involved with using it, and for many goods and services the costs are particularly high. The broad basket approach therefore must be ruled out as imposing unacceptably large storage and handling costs. There is, however, a way round the handling and storage cost problem: One could use a basket of future commodities instead of a basket of current (i.e., spot) ones. Because a commodity future is merely a promise to deliver a commodity (or its cash equivalent), commodity futures do not involve the storage and handling costs of spot commodities. Yet because the prices of spot and future commodities are closely linked, we can go a long way toward stabilizing a price index (i.e., the price of a spot basket) by adopting a symmetallic type of scheme based on a basket of commodity futures. My basic proposal is that the central bank should aim to stabilize the price level by pegging the price of an appropriately chosen basket of future commodities, and the best way to do that would be to peg the price of a price-index futures contract. If the central bank wishes to stabilize prices, this scheme offers it a simple and effective way to do so.

What Do We Mean by Price Stability?

Before discussing the central bank's choice of rules, we must first clarify what we mean by price stability and distinguish it from other related objectives. The term price stability has been used in the literature to refer to at least three different objectives. The first objective, and arguably the one to which the term price stability is least

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appropriate, is a *steady inflation rate* (i.e., an inflation rate that is roughly the same each year). The second is a *zero inflation rate*, and the third is a *steady level of prices*. The first is the least convincing. The benefits of a steady but positive inflation rate are highly questionable,[3] and there are serious drawbacks. There are good theoretical reasons to believe that even a perfectly anticipated inflation rate is damaging—individuals have to change prices more frequently, and changing prices is costly; inflation leads individuals to overeconomize on their holdings of real balances; and so on—and empirical estimates suggest that the losses involved are large (see, e.g., Driffil et al. 1990; Dowd 1994b). Even leaving aside those losses, there is also considerable evidence suggesting that higher rates of inflation are associated with a higher inflation variability or greater inflation uncertainty. That evidence suggests that one may not be able in practice to pick an inflation rate independently of the variability or uncertainty surrounding that rate, and that in turn suggests that the ideal of a steady but positive inflation rate may be a myth that cannot be realized in practice. There is also the problem that the choice of inflation rate is arbitrary and awkward to defend. If we pick an inflation rate of 5 percent, then why 5 percent and not 6 percent? If 6 percent, why not 7 percent? And so on.

If we reject the first objective, we still have to choose between the other two. Zero inflation and price stability are similar, but they differ in one important respect. If the price level for some reason turned out to rise this period, a price stability objective would require that the price level was subsequently brought down again to its initial level, but a zero inflation objective would "write off" the rise in prices and merely aim to stop prices rising any further in the future. While some economists dislike the idea of correcting price-level shocks, especially if that means that prices have subsequently to be forced down, I

[3]The most commonly cited benefit of a positive inflation rate is the "optimal inflation tax" argument due to Phelps (1973) that maintains that in a world where the government must resort to distortionary taxes, inflation should be positive because the inflation tax should be a component of that package. That argument has been heavily criticized—see, e.g., Dowd (1994b) and the literature cited there—but even if one were prepared to accept it, no one in practice actually knows what the implied optimal inflation rate actually is. Another argument sometimes made is that conventional price indexes are subject to a "quality change bias"—they tend to understate the impact of quality changes—which means that the reported annual inflation rate is typically 1 to 2 percent greater than the true quality-adjusted one. True price stability then requires not zero inflation but a positive inflation rate of 1 to 2 percent. However, the obvious reply to this argument is that government statistical agencies should alter the way price indexes are constructed and build appropriate quality-change allowances into them. But even if one accepts the argument at face value and opts for a positive inflation rate, the argument justifies only a very low inflation rate anyway, and it clearly cannot be used to defend inflation rates much beyond 2 percent.

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would nonetheless argue that price stability is the better objective. An important reason we care about the price level (and therefore the inflation rate) is that we believe private individuals need a stable and predictable monetary environment in which to go about their business, and a critical feature of such an environment must be a predictable price level. If prices are subject to shocks of various kinds, then of course perfect predictability will be impossible, but prices will be more predictable under a stable prices objective than under a zero inflation one. Under the former objective, an individual can expect that the central bank will counteract any price-level shocks that occur, and to the extent that such shocks are counteracted, an individual wanting to predict the long-term price level need not worry about interim shocks. Under a zero inflation rule, however, any inflation shock will be built into the price level with no tendency to be counteracted, and the same individual would have to worry equally about all the interim shocks that occur between now and some future period. The price level therefore will be less predictable under the zero inflation rule, and it becomes relatively less predictable the further into the future individuals try to make their predictions (see Gavin and Stockman 1991). If we are concerned about price-level predictability, as I believe we must be, we should choose a stable price-level objective over a zero inflation one.[4]

Monetary Targeting

If we wish to stabilize prices, most modern economists would suggest that the central bank target the rate of growth of the money supply to grow at the same rate as real money demand. If the demand for real balances grows at 2 percent a year, for instance, the money supply also should grow at 2 percent a year, if prices are to remain approximately stable. The central bank would announce a target rate of growth (or growth range) for a particular monetary aggregate, and then manipulate interest rates or the monetary base to try to ensure that the chosen monetary aggregate grows at the desired rate. Monetary growth rules were adopted by many countries from the mid-

[4]The argument in the text is of course by no means exhaustive, but my focus of interest in this paper is with *how* to achieve a particular nominal target, rather than with the *precise* choice of target as such. The text does, however, ignore nominal income targets, and one particular such target, the productivity norm, has recently received considerable attention (see, e.g., Selgin 1990, 1992; Yeager 1992). Under the productivity norm, prices would move inversely with changes in productivity, and Selgin has argued forcefully that the productivity norm would be superior to price stability. I strongly disagree, but refer the interested reader to the references mentioned and to the exchange between Selgin and myself in the *Journal of Macroeconomics* (Dowd 1995b, Selgin 1995).

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1970s onward, but their record is patchy, to say the least, and a number of countries moved away from them in the 1980s. In the United States, the adoption of monetary targeting was followed by a fall in inflation in the mid-1970s, but inflation subsequently rose again during the Carter Administration. It fell again after 1979, only to rise yet again in the Reagan years and then fall once more in the early 1990s to its current level of around 3 percent. Canada adopted monetary targeting in 1975, but there was no significant impact on inflation until around 1980, and the Bank of Canada gradually moved away from monetary targets in the years afterward. Britain adopted monetary targeting in 1976, but the choice of the wrong monetary aggregate played a large role in producing a very severe recession in the early 1980s, and monetary targets were subsequently deemphasized and eventually abandoned.

There are good reasons why monetary targeting was not more successful than it was, and they can be illustrated by means of Irving Fisher's equation of exchange in logarithmic form:

$$M + V = P + y, \tag{1}$$

where M, V, P, and y are respectively the logarithms of the money supply, the velocity of circulation of money, the price level, and real output. If the central bank were to use a monetary target to stabilize prices, it would aim to manipulate M to hit a target for P. A number of problems are then apparent. To begin with, the appropriate definition of the money supply (i.e., the choice of empirical counterpart for M) is far from obvious: Economic theory provides only weak guidance about it, and there is no consensus among economists, some preferring *M1*, others *M2* or something broader, or a divisia aggregate instead, and others a narrow aggregate such as the monetary base. There are also other problems. Unless the central bank picks the monetary base as the aggregate to be targeted, it does not control its aggregate directly, and it must instead try to influence it by manipulating the instruments at its disposal—the short-term interest rates it controls, or the monetary base. If the money supply function is volatile, or unstable, the central bank may be unable to hit its target within any reasonable margin of error, and the volatility of M will spill over and make P volatile as well. The successful implementation of monetary targeting also requires the demand for money—or, in terms of (1), the velocity of circulation V—to be reasonably stable and predictable. If it is not—and there is much evidence to doubt it is—the price level could still turn out to be a long way from its desired value even if the central bank managed to hit its monetary target reasonably accurately. If the demand for the monetary aggregate is

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unstable, it becomes difficult for the central bank to tell what values the instruments should take in response to changes in other variables (e.g., y), and it may miss its monetary targets by a considerable margin. Such problems are likely to be particularly acute in periods when the money supply process is subject to rapid technological and regulatory changes that make it very difficult for the central bank to gauge the impact of its policy actions. To make matters even more difficult, central bankers have to make their monetary policy decisions with little knowledge of how long their decisions take to work—the lags involved are variable and often difficult to predict—and with only a very imperfect idea of the state of the economy at the time their decisions are made. Not only do their decisions take time to become effective, but their information is imperfect and typically out of date by the time they get it. In short, monetary targeting is a very imperfect way to try to hit a price-level target.

A Gold Standard

While most modern economists have focused on monetary targets to achieve a desired inflation rate, economists in the past tended to think in terms of commodity price rules for central banks or other issuers of currency to follow. For them the most natural way to generate the price-level behavior one desired was to adopt a suitable commodity standard—a system of rules which imposed on the issuer(s) of currency the obligation to maintain a particular exchange rate between their currency and one or more commodities. If we think of the currency issuer as issuing $1 bills, a commodity standard requires him to ensure that the $1 bills always exchange for a given amount of a particular commodity or basket of commodities. Because the issuer would maintain a fixed exchange rate between the $1 bills and a particular quantity (or quantities) of one or more real goods, the nominal price of that good (or goods) would be fixed. Currency issued under those conditions is often said to be convertible.[5]

Commodity standards of one sort or another were the historical norm and prevailed from very early times until relatively recently. From time to time, a particular government might make the currency

[5]Convertible currency is to be distinguished from fiat currency, which is issued with no such guarantees and which trades in the market for goods and services at whatever exchange rate the market determines. While many modern economists and central banks like the freedom that a fiat currency gives its issuer, economists of older generations tended (in my opinion rightly) to view fiat currencies as harmful because they gave the issuers far too much license. It is no accident that the adoption of fiat currencies has been associated with so much inflation.

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inconvertible—the United States made the dollar inconvertible when the Civil War broke out in 1861, for example, and the pound sterling became inconvertible during the French Revolutionary War in 1797—but those lapses from convertibility were always perceived as temporary and convertibility was subsequently restored. Thus the U.S. dollar became convertible again in 1879 and the pound in 1821. However, in the 20th century, commodity standards came under attack from economists who believed that it must be possible to improve on them, and from governments and central banks that became increasingly impatient with the constraints they imposed on their ability to issue currency and manipulate interest rates as they pleased. Commodity standards gradually became discredited, the discipline they imposed on the issue of currency was undermined, and the last vestiges of the commodity standard were finally abandoned with the collapse of the Bretton Woods fixed exchange rate system in the early 1970s.

The most well-remembered commodity standard is the international gold standard that prevailed from the late 19th century. The gold standard was a system of rules that required the issuer of currency to maintain the exchange rate of currency against gold (i.e., it fixed the price of gold). If the demand for currency rose, individuals would go to the banks of issue and ask for gold (or, perhaps, some other asset) to be converted into the currency they desired to hold, and the banks would oblige them. If the demand for currency fell, they would go to banks of issue and ask for currency to be converted into gold or some other real asset, and the banks were obliged to satisfy their demands. The supply of currency thus accommodated itself to the demand for it, at prevailing prices, and an excess issue of currency could have only a very limited effect on prices because it would be returned to the banks of issue and retired from circulation.

The price level under the gold standard was then determined by the factors that determined the relative price of gold against goods and services in general. If rp_g is the log of the relative price of gold, the relative price can be decomposed into the nominal price p_g and the general price level P:

$$rp_g = p_g - P. \tag{2}$$

Under the rules of the gold standard, the nominal price of gold p_g is fixed, so the price level P moves inversely with the relative price of gold:

$$P = p_g - rp_g = \text{constant}—rp_g. \tag{3}$$

Any factors that alter the relative price of gold therefore alter the price level in the other direction. If there was a shock to the supply of gold such as a major gold discovery, for example, there would now

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be too much gold to clear the gold market at prevailing prices, and the relative price of gold would have to fall. Since the nominal price of gold would be fixed by the rules of the gold standard, the relative price of gold could only fall and clear the gold market if other prices adjusted upward. The gold discovery would therefore lead to a general rise in prices. If there were some development that led to an increased relative price of gold—increased economic growth leading to an increased demand for gold, perhaps—the gold market could clear only if the prices of goods and services elsewhere fell, and we would get a general fall in prices. Under the gold standard, the relative price of gold can fall if and only if other prices rise, and vice versa.

The gold standard has a number of attractions relative to the fiat (i.e., inconvertible) monetary systems that replaced it. One important feature that it shares along with all convertible monetary systems but not with fiat ones is that it provides a mechanism to ensure an automatic retiring of excess currency from circulation. Under a fiat system, there is no procedure to return excess currency to a central bank that issues more currency than people are willing to hold at prevailing prices. Prices then have to rise to restore equilibrium—and that of course is part of the reason why monetary growth under fiat systems has produced so much inflation. The gold standard also had the attraction relative to fiat systems that it provided the issuer of currency with simple (and manageable!) rules to follow. In effect it merely required that an issuer stand ready to buy back or sell its currency on demand from the public.[6] There was no need for currency-issuing banks to try to estimate the public's demand functions for currency or other monetary aggregates so that they could determine the volume of currency or deposits they should issue. All they had to do was honor their legal commitments and the volumes of currency and deposits, and indeed, interest rates, were determined automatically by market forces.[7] The gold standard was thus very simple to operate.

Nevertheless the gold standard also had its drawbacks. One obvious drawback was that the price level under the gold standard was only

[6]I ignore here any complications resulting from the possibility of indirectly convertible systems in which the banks of issue peg the price of one commodity or asset, but use another to redeem their currency when requested to by the public. The indirect convertibility issue is an important one, but we can ignore it for present purposes and the reader can assume for convenience that banks of issue actually handle the commodity or commodity basket whose price(s) they are fixing. For more on indirect convertibility, see Dowd (1995a), Schnadt and Whittaker (1993) and Woolsey and Yeager (1991).

[7]Central banks such as the Bank of England did have some influence on market interest rates even during the period of the classical gold standard before World War I, but their influence was still limited by the constraint of having to maintain convertibility. As a result, their freedom of maneuver was far more limited than that of a modern central bank operating a fiat monetary system.

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as stable as the relative price of gold. If the relative price of gold fell by 10 percent, the price level rose by 10 percent, and so on. If the relative price of gold was unstable, then so too was the price level, and the historical record of the gold standard suggests that this concern about price-level instability is not unfounded. The price level under the historical gold standard was rarely stable from one year to the next, but price changes were seldom as dramatic as those that have characterized the major economies since the collapse of the Bretton Woods system, and over the longer run there was a tendency for price-level movements to reverse themselves (see, e.g., Bordo 1992). The U.S. price level in 1914 was not much different from what it had been a century earlier. This price-level record is better than that of the fiat monetary system that replaced the gold standard, but it is still unsatisfactory if one's objective is a price level that is as stable as possible. In any case, even if one were prepared to accept the short-run price-level instability that characterized the period of the historical gold standard, there is no guarantee if the gold standard were restored that general price movements would continue to cancel out over the longer term as they did before. The gold standard may or may not deliver a more predictable price level than a continuation of the present fiat system, but it is still the case that one of the main arguments against a restoration of the gold standard is the price-level uncertainty that would arise because no one can predict the future relative price of gold with any high degree of confidence.

There is also another drawback. A gold standard involves certain resource costs—the costs of handling, and perhaps mining, the gold that is used in the operation of the gold standard. In the historical gold standard, people used gold coins, and gold coins were a more costly medium of exchange to produce and maintain than pieces of paper or bank deposits. It was also usually the case that banks would keep gold so that they could hand it out over the counter if faced with demands for redemption (i.e., conversion) by the public. Those resource costs gave rise to considerable concern, and their existence led many economists to argue that commodity standards were less efficient than fiat systems because the latter involved no comparable costs and could (it was claimed) deliver otherwise similar outcomes.[8]

[8]That argument is questionable because it ignores the benefits convertibility can bring or implicitly assumes that those benefits can be obtained at no cost by throwing away the convertibility guarantee and pretending that the fiat system can be expected to produce otherwise comparable outcomes. The problem is that a fiat system has a fundamentally different character—the issuer of currency faces very different constraints, and can therefore be expected to behave in a very different manner.

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There are reasons to believe the claims are exaggerated,[9] but there is no denying that the resource cost argument was a major reason many economists opposed the gold standard in particular and commodity standards more generally.

Commodity-Basket Monetary Systems

The drawbacks of a gold standard led economists to suggest a new type of commodity standard based on baskets of commodities instead of single commodities only. Concern with the price-level instability it created led Alfred Marshall in the 1880s to suggest a symmetallic system, one in which the value of the currency was tied, not to a particular weight of gold, but to a basket consisting of particular weights of gold and silver (see Marshall [1887] 1926). If p_b is the (log of the) nominal price of the basket, and rp_b (the log of) its price relative to the prices of goods and services generally, the currency issuer would peg p_b in just the same way as it would peg p_g under the gold standard. The (logarithmic) price level would then be given by

$$P = p_b - rp_b = \text{constant} - rp_b. \tag{4}$$

The distinctive feature of symmetallism is that p_b would be a weighted average of the nominal prices of gold and silver. Thus

$$p_b = a_g p_g + a_s p_s, \tag{5}$$

where a_g and a_s are given positive weights summing to 1.[10] The relative price of the basket is then

$$rp_b = p_b - P = a_g p_g + a_s p_s - P = a_g rp_g + a_s rp_s. \tag{6}$$

[9]Where banks were left relatively free under the gold standard, as for example in early 19th century Scotland, the evidence suggests that they could operate on remarkably low reserve ratios (see, e.g., Cameron 1967, 87–88), and those low reserve ratios implied that resource costs were also very low. In any case, economists who have pushed the resource cost argument against convertible currencies have generally overlooked the point that fiat systems have very significant costs of their own. Inflation and uncertainty lead to serious misallocations of resources—markets malfunction, agents feel obliged to invest resources to protect themselves from the consequences of inflation uncertainty, as illustrated by the growth of the financial services industry in the 1970s and 1980s, and so on. As Milton Friedman (1986) points out, those resource costs are highly significant, and my own assessment of the costs (Dowd 1994b) leads me to believe that the resource costs of a convertible monetary system are negligible in comparison.

[10]The text uses a geometric average for expositional purposes, but in the original symmetallist scheme, as proposed by Marshall, the symmetallist basket was to be an arithmetic weighted sum of commodities, so its price was an arithmetic rather than a geometric mean of the prices of the included commodities. The choice of arithmetic or geometric mean is fundamentally one of convenience only. Marshall also envisaged that the weights a_g and a_s would be fixed, but those could in principle be allowed to vary in accordance with rules of their own provided they still sum to one. To anticipate the later discussion, we might want to allow them to vary if the basket was meant to represent a typical consumer's shopping basket and that basket were to change over time.

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The symmetallic price level is then

$$P = \text{constant} - [\, a_g\, rp_g + a_s\, rp_s \,]. \tag{7}$$

In comparing (3) to (7), it becomes apparent that the relative price of gold enters the gold-standard price-level equation (i.e., (3)) with a weight of 1, but enters the symmetallic price-level equation (i.e., (7)) with a weight less than 1 (i.e., a_g). Changes in the relative price of gold therefore have a smaller impact on the price level under symmetallism than under the gold standard. The drawback, however, is that symmetallic price level is now also vulnerable to changes in the relative price of silver, whereas the gold-standard price level was not. On the other hand, if changes to the relative prices of gold and silver are not perfectly correlated, then shocks to those relative prices will to some extent offset each other. We might then expect, other things being equal, that a symmetallic system should produce a more stable price level than a gold (or silver) standard. The idea behind symmetallism is thus to make the price level more stable by exploiting any tendency of changes in the relative prices of individual goods to offset each other.

That basic principle can be extended further. If a system based on a basket with two metals produces a more stable price level than a system based on one metal only, we might expect a system based on a basket of three or more metals to produce a more stable price level still, as shocks to the relative prices of the individual commodities included in the basket tend to cancel out even more. Nor is there any reason to restrict the commodities included in the basket to metals. Nonmetallic commodities might also be included, allowing a much larger number of commodities to be included than would otherwise be possible, and in the process allowing one to choose commodities whose relative prices tended to move against each other and produce a more stable relative price for the basket.[11] If we pick a basket with n commodities, the price level is then given by

$$P = \text{constant} - [\, a_1\, rp_1 + a_2\, rp_2 + \ldots + a_n\, rp_n \,], \tag{8}$$

where the subscripts refer to each of the included commodities and the weights a_i again sum to one. Ideally, we can then produce a stable price level by selecting a broad enough basket (i.e., choosing a high value for n) and including the appropriate commodities in it.

[11]One of the problems with a purely metallic basket is that the shocks to the relative prices of the individual metals will tend to be highly correlated, so the relative price of a metallic basket will be less stable than the relative price of many a basket that included nonmetallic commodities, even if each basket had the same number of included commodities.

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There is consequently a good argument that basket-based commodity monetary systems will produce a more stable price level than monetary systems based on single commodities. There is however the problem that it appears to be very difficult to identify a suitable basket in practice. One possibility is Robert Hall's (1982) ANCAP basket—a basket of specified amounts of ammonium nitrate, copper, aluminum, and plywood—and Hall presented evidence to suggest that the purchasing power (i.e., relative price) of this basket in the United States had been stable over the period from 1950 to 1980. Yet it is doubtful that the ANCAP basket continued to have a stable relative price after 1980, and there is in any case no particular reason to have expected it to. Alternatives to the ANCAP have also proved remarkably difficult to find. Karl Brunner (1984), Alan Garner (1985), and James Boughton and William Branson (1989) all searched for but failed to find an equilibrium relationship between commodity price baskets and the U.S. price level, and my own attempts in 1990 to find a relationship between the prices of 11 internationally traded commodities and the (Australian) price level turned out to be a dismal failure. If a suitable basket really exists, no one can yet claim to have found it, and the commodity-basket scheme obviously cannot be operational without a tangible basket to work with.

There is also another serious problem: Commodity-basket systems involve higher resource costs, possibly much higher ones. It is one thing to keep gold coins on hand and pass them over the counter when faced with demands to redeem currency, but it is quite another to keep a basket of goods, particularly a broad one, and hand that over instead. The greater the number of commodities included in the basket, the greater we would normally expect the handling, storage, and other costs involved to be, and the more expensive the monetary system would be to operate. The problem is that each commodity has as it were its own storage and handling needs, and those needs impose certain costs that must be borne if the commodity is to be included in the basket. If a precious metal were included, we would normally need a strongroom of some sort; if a frozen commodity were included, we would need refrigeration facilities; and so on. In some cases, one could perhaps add a new commodity that could be handled with minimal additional costs—if one had the facilities to store gold, one might perhaps be able to add silver at no significant extra cost—but if they existed at all, such cases would be the exception rather than the rule. As we broadened our basket and included more commodities in it, we should therefore expect that the costs of handling a basket of a given nominal value will generally increase. In any case, as the basket gets broader, one will at some point have to deal with

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commodities that depreciate over time (e.g., perishable goods), or are otherwise relatively costly to store (e.g., because they are bulky), or do not come in easily recognizable or manageable lumps. To some extent, perhaps, we could ameliorate the problems caused by having indivisible goods in the basket by dealing only in high-value baskets—having rules that require the issuers of currency to redeem their currency in units of $1,000, say, to prevent them from being forced to hand over a little basket of goods when someone comes in with a $1 bill—but dealing only in high-value baskets does not fully solve the indivisibility issue and does nothing about some of the other problems (e.g., perishability).

There is, moreover, a deeper aspect to this general problem. The physical characteristics of some commodities mean that the resource costs of including them in the basket are very high (e.g., for highly perishable commodities). Pursuing this line of thought further, many commodities involve resource costs so high that those costs are effectively unlimited. There are commodities whose physical characteristics mean that it is impossible (or almost impossible) to include them in a basket (e.g., nuclear power stations), but the same also applies to many services. It is possible, maybe, to have a basket that included hair-styling of a particular kind, but it would not be easy for a central bank that operated a commodity monetary system based on such a basket to physically deliver the particular services involved. It might keep a hair salon on the premises, perhaps, and employ stylists to stand ready to deliver the service included in the basket, but the same logic that says it should keep a hair salon also suggests that it should keep a bakery, a bar, a public recreation center, and who knows what else. It does not take much imagination to see how high those resource costs might be, and one cannot reasonably to expect the central bank to be able to deliver commodities or services like these. We therefore have little choice in practice but to exclude a large number of goods and services from our basket if we wish to keep our resource costs down to tolerable levels.

The Conflict Between Price-Level Stability and Low Resource Costs

It might help to summarize where we stand. If we want price-level stability from a commodity monetary system, we have good reason to prefer a system based on a basket of some sort, if a suitable one can be found. We also have reason to believe that, other things being equal, a system based on a broader basket would deliver a more stable price level than a system based on a narrower one. If we ignore any

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resource-cost issues for the moment, the best basket—the one that delivers the most stable price level—is clearly the same basket as the basket whose price is represented by the price index we wish to stabilize. If we wish to stabilize a particular price index, and this index is itself a weighted average consisting of a_1 times the price of good 1, plus a_2 times the price of good 2, and so on, we can think of the price index as representing the price of a basket consisting of good 1, good 2, and so on, all in particular quantities implied by the way the index is constructed. If we wish to stabilize the consumer price index (CPI), for example, we would select the CPI basket, the basket whose price the CPI represents. The relative price of the basket against goods and services in general, as proxied by the price index itself, is consequently 1 (i.e., constant). The price level is

$$P = p_b - \text{constant} \tag{9}$$

and is as stable as the nominal price of the basket itself. The price level can then be stabilized by pegging the nominal price of the anchor.

The problem, of course, is that we have left out the resource costs. Resource costs tend to rise as the basket gets broader, and the resource costs of a CPI basket are effectively unlimited. A broader basket means a more stable relative price, and hence a more stable price level, but it also means higher resource costs, all on an other-things-being-equal basis. We thus face a dilemma—we can choose a broad basket with good price-level stability properties and very high resource costs, or a narrow basket with tolerable resource costs that delivers a poor degree of price level stability. From the point of view of CPI stability, our presumed objective, our ideal basket, the CPI basket, involves resource costs so high that it must be dismissed as unfeasible. To add to our difficulties, if we rule out the CPI basket on resource-cost grounds, it is not clear what other basket we can turn to. No one has yet identified a suitable flesh-and-blood basket that might involve tolerable resource costs. We appear to have gone up a blind alley.

A Commodity Futures Basket?

A possible way out is to think in terms of future commodities (i.e., commodity futures) rather than present (i.e., spot) ones. A commodity in the future is in many ways very similar to a commodity now—the difference is that one has not yet taken delivery of it, so the difference between a futures contract and a spot one is that the former calls for future delivery (or its equivalent) and the latter calls for delivery now—but for our purposes what matters is that their prices will still move very closely with the price of the corresponding spot commodity.

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If the price of spot commodities rises, we would expect that prices of the same commodity to be delivered at some time in the future would normally rise as well. The nearer the delivery date, the closer we would expect the correspondence between the two prices to be. If one rises, arbitrage will normally ensure that the other rises as well.

Because these contracts are only promises to deliver, the owner of such a contract does not actually have to handle the commodity concerned, at least until the maturity date arrives, and sometimes not even then.[12] The trading of the contracts therefore involves no resource costs to speak of, and the costs are negligible regardless of the costs of handling the corresponding spot commodities. Agents can hold whatever forward or futures contracts they want and still bear negligible resource costs provided that they do not find themselves forced to take delivery of the commodities concerned when the contracts mature. If the prices of forward or futures contracts move closely with the prices of the corresponding spot contracts, and if handling those contracts involves negligible resource costs, there is a simple solution to our earlier dilemma: we simply replace the spot goods and services in our basket with their futures equivalents.[13]

A futures contract is an agreement that *A* should deliver a particular amount of some commodity to *B*, or make an equivalent payment to him, at a specific future time *T*. In a simple futures contract, the price is agreed now, and some proportion of the price is paid now, and the rest paid on maturity (i.e., at *T*). This proportion is the margin requirement. This margin requirement turns out to be important to ensure that the money supply is appropriately corrected, and it is easiest if we simply assume that the margin requirement is 100 percent. *B* therefore pays all the price now, when the contract is made.[14] If the contract calls for physical delivery of the commodity, *A* delivers the commodity at *T*, but if the contract called for cash settlement, *A* instead pays him whatever is needed to buy the specified amount of the commodity concerned on the prevailing spot market. Since *A* commits to the future physical delivery or equivalent cash payment, *A* is said to sell the futures contract to *B*, and the payment *B* makes to *A* in return is the price of the contract.

[12]Because resource costs as I have defined them only arise when one actually has the physical good, one can still avoid them when the contract matures if the contract calls for settlement in cash of equivalent value.

[13]The idea of using futures prices to help deal with inflation is not new, but it is only very recently that schemes have been suggested to use them to stabilize the price level. For more on this type of scheme, see Sumner (1989) and Dowd (1994a).

[14]I thank Bill Woolsey for very helpful correspondence on this point.

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To see how the price of a typical contract is determined, suppose that both agents have the same expectation of the spot price of the commodity at T. Suppose also that both agents have the same attitude toward risk—if one likes, one can think of both agents as being risk-neutral—and there is no significant default risk on the contract. If the price of the contract is too high, in a sense to be explained shortly, a typical agent will prefer to sell the commodity now in the futures market than later on in the spot market. He will judge that he will be better off selling now and investing the proceeds at the going interest rate than he would be waiting until T arrives and selling then. There will then be an excess supply of futures contracts relative to (expected) spot ones, and the price of futures contracts will fall relative to the (expected) future spot price. If the futures price was less than the expected spot price, the same agents would expect to be better off waiting until T arrives and then selling than they would be selling now on the futures market and investing the proceeds until T. There will now be an excess demand for futures contracts relative to (expected) future spot ones, and the price of futures contracts will rise relative to the expected future spot price. The price of futures contracts would therefore keep changing until it was equal to the discounted expected spot price of the commodity concerned. If F is the (log) price of the futures contract, and S the (log) spot price, arbitrage would ensure that

$$F = f(.) + ES, \tag{10}$$

where $f(.)$ is a stable function that makes allowance for the interest cost due to some of the payment taking place when the contract is made,[15] and E is an expectations operator indicating that (10) relates F to the expectation of S. If the term to maturity of the contract is short, then $f(.)$ should be close to zero and

$$F \approx ES. \tag{11}$$

The story has to be modified slightly if agents on either side of the market differ in their attitudes toward risk, but (11) holds even in this case, and the key point is that the price of the futures contract is still closely tied to the expected spot price of the commodity on the maturity date. One price cannot move far without dragging the other with it.

[15]Ignoring risk and related factors, if r is the rate of interest over the term of the contract and θ is the margin requirement, then $f(\ ) \approx \ln[\theta/(1+r)]$. If the term to maturity is short, then r should be small, and $f(\ ) \approx \ln \theta$. It follows, then, that while $f(\ )$ does depend on r, we can normally ignore that dependence if r is small (as it would be, in particular, if the contract has a short term to maturity).

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The basic idea behind the proposal is that we should aim to stabilize the price level by exploiting the fact that futures prices move very closely with expected spot prices, and therefore with *ex post* spot prices as well, but handling futures contracts does not involve the resource costs incurred in the handling of many spot commodities and services. One way to implement the idea would be to deal in futures contracts for all the commodities whose prices appear in the price index we wish to stabilize, but doing so would still involve considerable transactions costs—we would have to deal with a large number of different contracts—and there is the additional problem that futures contracts for most of those goods and services do not currently exist anyway. We would therefore have to set up the appropriate markets so that we could deal with the contracts traded in them, and then incur all the transactions costs involved in handling them.

There is, however, a much easier alternative. Instead of trading in a large number of futures contracts for individual commodities, we could trade in a single *price-index futures contract.* A price-index futures contract is a contract to make a payment contingent on the realized value of the appropriate price index at the time stated in the contract. If the earlier futures contracts were contracts to deliver particular individual commodities or make equivalent cash payments, we can think of a price-index futures contract as a contract to deliver the monetary equivalent of the bundle of goods and services whose price the price index represents. If the price index is the CPI, the central bank would therefore trade in CPI futures contracts. The proposal is then very straightforward: *the central bank should be committed to pegging the price of CPI futures contracts of a given relatively short maturity. Since spot prices and futures prices are closely linked, pegging the price of CPI futures would tend to stabilize the spot price of the CPI.* In notation used in the previous two equations, the spot price S is now the CPI (i.e., P), and the futures price F is now fixed. The expected price index is therefore

$$S = EP \approx \text{constant}. \tag{12}$$

The actual price index P is then given by the expectation of P and a random error ϵ that picks up the unanticipated movement in P that was not foreseen when the futures contract was made:

$$P \approx \text{constant} + \epsilon. \tag{13}$$

The actual price level is approximately constant, give or take a random error ϵ. If agents are rational, the price-forecast error should be unpredictable, so ϵ should have a mean of zero. The variance of the price level (i.e., var P) would then be

$$\text{var } P \approx \text{var } \epsilon, \tag{14}$$

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that is, the variance of the price level would be approximately equal to the variance of the price-level forecast error.

There are two points to note about the behavior of the price level under the proposed rule. First, the price level should have a constant mean, as given by (13). There should be no trend rate of change in the price level over time, and the mean rate of inflation should be roughly zero. Second, the variance of the price level would be approximately equal to the variance of price-level forecast errors. We cannot predict this variance exactly, but one can form some idea of what it might be from price-level forecast errors from the recent past. To give an illustration, Dennis Jansen (1989, Table 4) presents results for the United States for the period 1959:I to 1988:II that indicate that price-level forecast errors had a variance of about 1.40 times 10^{-5} (i.e., 0.000014), or a standard deviation of about 0.37 percent. If we assume that the price level would be just as predictable under the new rule as it has been in the recent past, then (13) suggests that the price level itself would have a standard deviation in the region 0.35–0.4 percent. However, the absence of monetary policy shocks under the new rule should actually make the price level more predictable under the new regime, so the standard deviation should be somewhat smaller than that range suggests. In short, adopting the proposed rule should lead to a price level that has an approximately constant mean and a standard deviation (to be conservative) of under 0.4 percent.[16]

How the Scheme Would Operate in Practice

To see how the scheme would actually work in more detail, suppose that agents for some reason expected the future value of the price index to rise. If the expected future value of the CPI was too high relative to the (given) value of the CPI futures contract, arbitragers would wish to buy futures contracts now and make provision to sell the commodities spot when the maturity date arrived. The central bank would have to create the additional futures contracts the private agents demanded and sell the contracts to them at the price the central bank was maintaining. Because the purchasers would have to

[16]Apart from trying to tighten up the approximation error in (12) and get a more precise estimate of the variance of the price-level forecast error, it is not clear how much more one can do to predict the behavior of the price level under the proposed rule. The price level forecast shocks ϵ are by their nature unpredictable, and it is not clear (at least to me) how one could confidently simulate them. One possibility, perhaps, would be to use CPI futures data from the U.S. CPI futures market that operated between 1985 and (in effect) 1988, but the market was so thin and data set so short that one must wonder what such an exercise would really tell us. For more on the U.S. CPI futures contract, see the text below and Horrigan (1987).

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hand over money at the time they agreed on the contracts—remember the margin requirement[17]—the central bank would be buying back base money in the process and retiring it from circulation. The money supply would fall, and the falling money supply would help reduce the expected value of the future CPI toward its equilibrium value. This equilibrating process on the part of arbitragers would also be reinforced by the behavior of primary suppliers and purchasers. If the future expected spot price was too high relative to the currently prevailing futures price, a typical supplier of goods would expect to make higher profits from selling the good in the future, and so would make plans to increase the supply to be brought to the market. The supplier also might hold back supplies he was planning to sell in the current period to sell them later instead. Similarly, those who purchase goods will anticipate higher future prices and demand more now with a view to demanding less in the future. Both demanders and suppliers will therefore respond in ways that increase excess supply in the future and thus help to bring down expected future prices, and they will continue to alter their plans until expected future prices have been brought down to levels compatible with the pegged price of the CPI futures contract.[18]

The commitment of the central bank to peg the price of CPI futures contracts also would ensure that the new contract found the market it needed to make the central bank's rule deliver the desired outcome. As briefly mentioned in note 16, a CPI futures contract was traded between 1985 and 1988, but trading was so thin that the contract was eventually withdrawn by the exchange that sponsored it, the Coffee, Cocoa, and Sugar Exchange in New York. The reasons for the failure of CPI futures to catch on are not entirely clear. Brian Horrigan (1987) suggests that prices might have been relatively predictable over that period, and so there would have been little incentive to take out the protection that the contract offered. He also suggested that

[17]The margin requirement is crucial. If there is no margin requirement, no base money is retired at the time the contract is made, and the equilibrating mechanism described in the text does not come into play: Significant margin requirements are necessary to ensure that base money is retired or increased at the time that contracts are made. Again, I thank Bill Woolsey for his correspondence on this point.

[18]One objection made to this scheme is that if prices are sticky, it might take time for the price index to adjust, and delays in the response of the CPI might produce destabilizing swings in the money supply and, perhaps, real output. However, the equilibrating process captured by (10) and (11) requires that it be expected prices that adjust, rather than spot ones, and there is no reason to expect expected prices to be as sticky as spot prices might be. Provided the term to maturity is not too short, many of the components of the expected CPI will adjust even if their counterparts are sticky, and destabilizing movements in money supply and associated effects should by and large be avoided.

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the failure of the CPI futures contract might have had something to do with the absence of an underlying asset, an absence that would have discouraged some traders and therefore kept the market thinner than it might otherwise have been.

I believe the contract proposed here would find the market it needs despite the earlier failure, because of the central bank's obligation to peg the price of the new contracts. (The central bank of course had no such obligation with the previous CPI futures contracts.) The argument is as follows: Suppose the central bank adopted the new policy and there were no takers for the contracts it was offering to buy and sell. The equilibrium condition (10) then tells us that the money supply, interest rates, and so on, must be roughly compatible with the desired outcome (i.e., stable prices). We would therefore have nothing to worry about. If the money supply and so on were to deviate from the levels compatible with the equilibrium conditions, on the other hand, then those conditions would no longer hold, and it would be worthwhile for some private agents to buy or sell contracts at the fixed prices the central bank was offering. The market would then come alive, and it would remain alive for as long as it needed to in order to bring about the changes to base money and so on required to restore equilibrium. In short, the equilibrium condition (10) and the fixed price offered by the central bank would ensure that private agents had the incentive to make the trades necessary to produce the desired outcome.

The commitment of the central bank to peg the price of CPI futures contracts also prevents it from increasing the supply of base money beyond the level compatible with the pegged price of those futures contracts, in much the same way that the commitment to maintain the price of gold prevented banks of issue under the gold standard from issuing excess currency. Like banks of issue under the gold standard, the central bank would effectively commit itself to supply base money on demand. If the public want more base money, they would come to the central bank to sell it futures contracts, and the central bank would buy the contracts from them and give them the additional base money they want. If the public want less base money, they would come to the central bank wanting to exchange base money for futures contracts, and the central bank would oblige them. The central bank's operating rule would be to maintain the price of futures contracts, and it would create or retire base money on demand to ensure that the price of those contracts remained at the level it was supposed to. The commitment to peg the price of futures contracts prevents the central bank from issuing too much base money. Like the gold standard rule, the CPI futures rule would be a very simple

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one to operate, and the central bank would no longer have to worry about the most appropriate definition of the money supply or whether money demand had shifted.

The rule proposed here could also deal easily and automatically with shocks or other exogenous changes in the economy. Suppose, for example, that there was another oil price hike, as in 1974 or 1979. If non-oil prices remained the same or rose, and that state of affairs was expected to continue, then the expected value of the future CPI would rise and the equilibrating forces discussed earlier would come into play. Agents would demand additional contracts from the central bank, expected future excess supply would rise, and the expected future value of the CPI would fall to a level consistent with the price of the CPI futures contract as pegged by the central bank. If oil prices have risen, however, the value of the CPI can only fall back again if other prices fall, so non-oil prices would on average have fallen. What happens is that relative prices adjust to the oil price shock, but they adjust in such a way that the average price level as measured by the CPI is restored pretty much to its initial level.[19]

The monetary system responds in the same way to secular or cyclical changes in the demand for real balances. Should the demand for real balances rise because of economic growth, for instance, we would expect there to be a higher demand for base money as well. Agents who wanted additional base money from the central bank could then create CPI futures contracts to sell for the central bank in exchange for base money, and the money supply would rise to a level consistent with the new demand for real balances at prevailing prices. If income fell and the demand for real balances fell with it, on the other hand, there would be an excess supply of base money at prevailing prices, agents would retire the excess base money in return for futures contracts, and money supply would fall until it was consistent with the

[19]Some economists would question whether it is desirable that the CPI should return to its previous value—for example, one often hears the argument that shocks such as oil shocks should be accommodated. This type of argument is usually based on assertions that certain prices or wages are sticky downwards, and that this stickiness is sufficiently serious that monetary policy should accommodate it. I do not find these assertions convincing. Accommodating monetary policy merely allows the price level to rise, and it is doubtful that countries that pursued accommodating policies in the face of the first oil price shock in 1974, such as the United Kingdom and the United States, fared better than countries that made more of an effort to absorb the shock, such as Japan. I also find it odd that the depression of the 1930s, in which prices in the United States fell by around a third, should have led so many economists to believe that prices are sticky downward. In any case, I would argue that either we want price-level stability or we do not. If we do want it, and certain prices rise, then other prices must necessarily fall, and we can do nothing about it. If we want other prices to rise as well, or we want to resist their falling, we no longer want price-level stability.

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lower demand to hold money balances. Whether the demand for money rises or falls, or whether those changes are secular ones or cyclical ones, the supply of money would respond in much the same automatic way to meet the new level of demand at much the same level of prices as that which prevailed before.[20]

Another important point to note is that the rule proposed here is not open to successful speculative attack provided that the central bank commits itself effectively to it. Price-fixing rules can only be open to successful speculative attack if private agents expect the pegged price—in this case, the price of the futures contract on the days when the central bank intervenes in the futures market—to change. If the central bank's commitment were credible, rational private agents would not expect this price to change, and there would be no point speculating against the central bank's price-pegging rule. It would only be worthwhile speculating against it if there were a significant probability the central bank would abandon it—which would not be the case if the commitment were credible, as it should be—or if the rule called for periodic changes in the pegged price, as in a crawling-peg exchange rate system—which the rule does not. There is thus every reason to believe that the rule proposed here would be safe against speculative attack.

There remain only the operational details of how the scheme would actually be implemented.[21] The central bank would not be required to intervene each day to peg the price of futures contracts, as it intervened each day under the gold standard to peg the price of gold. If the CPI is announced once a month, it would suffice for the central bank to intervene in the futures market one day a month to peg the prices of contracts of the chosen maturity.[22] Arbitrage forces could then be relied on to ensure that the prices of futures contracts on other days were roughly consistent with the prices of those contracts on the central bank's intervention days. Creating the market for these CPI futures would be very simple: All the central bank would need to do is decide on the price at which it intended to buy and sell those

[20]One may ask why prices remain much the same. The futures price rule ensures that the expected price level is (approximately) constant. By (12), the actual price level remains much the same, give or take the error term ϵ. If a change in money demand or relative prices has any effect on the price level, that effect must be a relatively minor one.

[21]For more on these details, see also Dowd (1994a).

[22]The central bank need not intervene the same day as the CPI is announced, but it should intervene the same day each month. The difference between the futures and expected future spot prices involves an interest component, and if the central bank intervenes on different days in different months, the interest component varies and moves the expected spot price around unnecessarily.

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contracts, and it would then leave it to private agents to come and trade with it. If there was not enough money in circulation to produce a price level consistent with the pegged futures contract price, private agents would find it worthwhile to come and obtain additional base money from it by selling it futures contracts, the money supply would rise, and so on. If there was too much money in circulation, private agents would present it for redemption by demanding futures contracts from the central bank, and so on. The central bank would have only to choose the days when it wanted to intervene to peg the futures contract prices, and the price at which it wanted to peg them. The latter, in principle, is arbitrary, but if the central bank were concerned about price stability, as it surely should be, it would presumably pick a value consistent with the value of the price level at the time the new system was introduced. The price level would in effect be tethered to a value close to its previous prevailing level, and there should no significant transitional jump in prices as the new regime was introduced.

Conclusion

Central bankers have often claimed that they would like to eliminate inflation, but lack a technically efficient means of doing so. Monetary targeting is very imperfect for all sorts of reasons. Traditional commodity standards such as the gold standard are much easier to operate, but the price level still fluctuates with changes in the relative price of gold. Economists have long suggested that a way round the latter problem would be to peg the price of a basket of commodities rather than the price of a single individual commodity, and the broader the basket, the more stable the price level would be. However, broad baskets also involve high resource costs of one kind or another, and the basket we would really like to stabilize—the basket of goods and services behind the CPI—involves such massive resource costs that we have no alternative but to dismiss it as unfeasible.

There is however a very simple solution. Instead of stabilizing the spot price of the CPI, the central bank should stabilize the price of CPI futures. The beauty of futures contracts is that their prices are closely linked to the prices of the corresponding spot commodities, but handling futures contracts involves no resource costs worth speaking of even if the resource costs of handling the corresponding spot commodities or services are high. A central bank can handle such contracts even when resource costs prevent it from handling the spot commodities or services underlying them.

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The Folly of Anti-Scalping Laws

Stephen K. Happel and Marianne M. Jennings

One of the basic principles in economics is that competititve markets generate price movements to bring quantities demanded into balance with quantities supplied so that queues will be quickly eliminated. Lines, therefore, are troubling to economists, especially when the lines appear repeatedly in what seem to be nonregulated markets. Why are price increases not more forthcoming?

Natural disasters create one such situation. Essentials like water are sold at "below-market" prices immediately after the disaster, as evidenced by long lines of consumers. A completely free-market solution would be to have many different firms supplying water at prices the market will bear. However, perceptions of fairness are so strong in natural disasters that price gouging is either illegal or heavily criticized by most consumers. Charging what the market will bear in the short run generates extremely adverse "moral effects" (Akerlof 1984) or "reputation effects" (Klein and Leffler 1981) in the long run. Because of consumer perceptions about fairness and moral treatment, below-market pricing continues—and queues remain for some time.

Another situation of persistent lines and strong feelings about equity is entertainment events such as major concerts or big-time sport championships. Well-known performers and certain games repeatedly have people lining up for tickets for the right to attend the live, one-time interactions. Again, why do promoters not raise prices at the time tickets first go on sale to prevent long lines? Are the lines rational in a market sense, helping to ration a scarce commodity? Further, why do many promoters and certain consumers become so outraged by the attempt to clear markets through ticket scalping? Currently

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26 states, the District of Columbia, and most sports-league municipalities in the United States have some form of anti-scalping regulation, and three-quarters of the U.S. population resides in those locales. (See Table 1 for the states and cities involved.)

This paper examines the nature of major entertainment events, reviews the evolution of scalping statutes since 1918, describes various schemes for allocating tickets, considers the winners and losers in each scheme, and suggests some ideas about possible future scalping laws based on market principles.

The Nature of Entertainment Events

Entertainment events occur in specific locations at specific times. Such events include county fairs, open-air dances, and other situations in which the notion of capacity is relatively fluid. However, the focus in this paper is on events that take place in a concert hall, amphitheater, or stadium with a fixed seating capacity. Consequently, demand is the prime determinant of price. For such events, promoters or team owners must sell tickets in advance with a printed face value, much like firms issuing common stock with a par value or a contract being sold in a futures market. Most critically, the events have a quality of uniqueness, such as a one-time concert appearance or a once-per-year rival football game.

Consumer Behavior

Consumers enjoy those unique, limited-seating, live events in part because of the performance on stage or on the field. There is something intriguing about observing the action firsthand. Some consumers may not even care whether anyone else is present. For them the thrill of the live performance is enough.

Other consumers, however, want more. Along with the performance itself, they want the ambience that comes from being part of a group. They like shared experiences such as doing the wave, lighting candles, or yelling at players or performers. The idea that group actions affect individual consumption behavior can be traced to the notions of Thornstein Veblen, snob appeal, and bandwagon effects (Leibenstein 1950). Recently, Roger Faith and Stephen Happel (1989) coined the term "mob goods" to describe concerts and sporting events in which expected attendance strongly influences demand by consumers.

The mob effect, or perhaps more appropriately the crowd effect, as suggested by Lawrence Ritter in reading an early draft of this paper, is crucial to understanding ticket scalping and related pricing

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behavior.[1] The crowd effect makes each event unique. There can never be duplication of an event with the same crowd even if essentially the same performance occurs. The ambience exists at the moment. The uniqueness, in turn, means that special memories are created for consumers. The memories can be drawn on over and over again, for example as consumers think about their first Super Bowl, World Series, or NBA finals.

The uniqueness and related memories explain why some consumers feel so strongly about attending such events and having "fair" access to tickets. Certain consumers are willing to wait in line because they believe that selling seats first-come, first-served at the printed face value of a ticket represents the best way to ration scarce seats. They trade their time in line for the money saved from having to pay a higher price. Further, they even may derive utility from the queue itself. There can be a crowd effect from waiting with a certain group of people, and anticipation may be heightened through the time spent in line. Lines seem perfectly rational to such consumers, and they detest the thought of paying any amount above the printed face value.

Producer Behavior

Producers, team owners, and concert promoters are profit maximizers. They have a certain degree of monopoly power for an event because of its uniqueness. In addition, they may exercise considerable monopoly power over selected seat locations because some locations (front-row center, club seats, suites) are preferred to others. Given this monopoly power, producers want to charge what the market will bear and to engage in price discrimination whenever possible.

At the same time, producers typically want sellouts. One reason for the full capacity desire centers on the demand dynamics associated with the crowd effect. The perception that an event will be a sellout attracts consumers into the ticket market who would not attend otherwise, and the ambience from a sellout may intensify the demand by consumers for future events. A second reason for promoter desire for a sellout is to maximize complementary revenues from parking, refreshments, and souvenir sales at the stadium or concert hall. There is also an important cost element. Typically, the marginal costs associ-

[1]Stephen Happel and Marianne Jennings (1989) began with the notion of mob goods in providing reasons for low prices by promoters and in looking at general problems with the regulation of scalping. Gary Becker (1991) also assumed that demand is positively related to quantities demanded by other consumers to provide insights into pricing by successful restaurants, plays, and sporting events characterized by persistent excess demand. Roger Faith and Allan DeSerpa (forthcoming) focused on the idea of crowd reaction/noise in a further elaboration of mob goods, equilibrium queues, and welfare effects of ticket scalping.

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TABLE 1

ANTI-SCALPING REGULATION: STATE AND MUNICIPAL LEVEL

Form of Regulation	States Adopting	Municipalities Adopting[a]
Limits on resale price (include such limits as $1 above printed price; $3 service charge; percentage limitations)	Arkansas, California, Connecticut, Florida, Kentucky, Maryland, New York, Pennsylvania, Rhode Island, Tennessee, Wisconsin	Washington, D.C.
Owner/promoter authorization for resale above printed ticket price	Arizona, Connecticut, Michigan, Minnesota, Missouri, North Carolina	Ann Arbor, Atlanta, Detroit, Edmonton, Portland, Virginia Beach
Location restrictions on scalping (no sales at event site, on state property)	Arizona, California	Anaheim, Arlington, Atlanta, Chicago, Cincinnati, Dallas, Edmonton, Milwaukee, Washington, D.C.
Ticket sales and resales limited to printed price	Louisiana, Maryland	Anaheim, Ann Arbor, Atlanta, Baltimore, Denver, Edmonton, Green Bay, Joliet, Kansas City, Los Angeles, Seattle, St. Louis

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Scalping prohibited only in certain events (e.g., athletics)	Georgia, New Mexico, South Carolina	Baltimore, Calgary, Cincinnati, Milwaukee, Minneapolis, New York, Washington, D.C.
Broker licensing	Alabama, Illinois, Massachusetts, New Jersey	Atlanta, Seattle, Virginia Beach
Municipalities to regulate	South Dakota, Virginia	
Charity/nonprofit exceptions for resale	Louisiana, Virginia	

[a]Those cities listed in more than one category have anti-scalping ordinances with multiple components. For example, Atlanta prohibits sales in excess of the printed ticket price unless such resales are for charity or are authorized by the owner or promoter. Further, Atlanta prohibits all resales of tickets within 20 feet of the event.

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ated with additional attendees, after basic maintenance and staffing expenses are covered, are low until capacity is reached.

Promoter desire for a sellout often is combined with a preference about the mix of consumers actually attending the event. Owners and promoters may want true fans in the seats, or they may want to create a particular atmosphere, for instance an event for the entire family (Nager 1985). Creating a situation where not only the rich and powerful receive all the tickets generates positive morale effects. So producers often may want to control who among the public is buying tickets.

While producers have a degree of monopoly power, market and regulatory constraints limit firm behavior with respect to ticket pricing. Market constraints exist because fans can quickly lose interest in teams or artists whose performances do not meet expectations or who create perceptions of price gouging. Groups and performers go quickly from being "in" to being "out." Both event attendance and complementary sales suffer as a result. Legal constraints include a multitude of state and local statutes prohibiting resale of tickets above face value or at given locations. Major sports franchises are prohibited by league rules from charging above a stipulated price for various seat designations, raising or lowering the per-game printed price of the ticket once they are set for the season, and actively engaging in ticket scalping.

Faced with market and legal constraints, producers may purposely set the price of certain seats low (often general admission) to induce a line. The low price signals consumers that there will be likely significant demand for tickets and that the event will be well-attended or sold out. Producers recognize that sizable numbers of consumers are willing to trade time in line for money to acquire tickets and that many of those consumers are strong fans whose support is needed for ongoing profits.

At the same time, producers may try to increase returns in selected seats through the widespread phenomenon of "holds." Holds are the better seats kept back by producers from the public when general admission seats go on sale. Lines for the general admission seats can be used to determine the market value of the holds as separate from their printed face value. If the line is lengthy, then producers may request special favors from radio stations, local politicians, or other influential individuals as they are "given" tickets. Or producers may decide to sell the holds directly to ticket brokers if the market price becomes significant.

From both the producers' and consumers' perspectives, then, lines are rational for reasons not present in traditional demand models. In the case of high-demand, limited capacity events, lines do not necessarily represent miscalculations or errors in judgment. Instead, they

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are a rational part of a market structured around the importance of a queue.

Ticket Scalping and Legal Responses

A secondary market for high-demand, limited-seating-event tickets always exists and creates the opportunity for ticket scalping. Ticket scalping is most frequently defined as buying (tickets) for later sale at higher than normal prices. "Buying for later sale" points to a third set of agents in the market along with consumers and producers. "Higher" is based on the often-held perception that tickets are resold only for more than was paid, but scalping in the broadest sense also encompasses the resale of tickets for less than paid. "Normal" harkens back to the notion that printed face value is the norm.

The secondary market occurs because seats are sold in advance of events. When a line is expected, ticket scalpers are present because time may not be a readily available commodity for some purchasers. Those buyers would prefer to pay with more money. Typically, those consumers have a high opportunity cost of time and view scalping as a legitimate market exercise. Scalpers are simply time brokers who perform a useful service.

However, it is crucial to recognize that even when a line is not expected when tickets first go on sale, either because an event is not a sellout or because the printed face value clears the market perfectly and a sellout is achieved, scalping is inevitable. Some consumers with tickets will decide not to attend. They want to get rid of their tickets. Others are in the market for (good) seats up to the time of the event. Reallocation is the natural outcome.

Producers, while wary of the process, must accept reallocation in some form. If the consumers who initially purchased the tickets from producers had to occupy seats or let them go empty, the advance demand for seats would drop considerably. Accordingly, producers accept "giving away" tickets to relatives, friends, or business acquaintances, and they generally see resale at printed face value for sellouts as "fair." But they dislike nonregulated scalpers for a number of reasons. When excess capacity exists and scalpers are outside the stadium selling tickets below face value, producers complain about the loss of revenue from the seats they are offering for sale at the box office that are going unsold because consumers are buying seats from scalpers. When tickets are sold by scalpers well above face value, producers complain about receiving none of the profit. And when scalpers are loud or aggressive, producers complain about nuisance effects.

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Jerry Colangelo, president of the Phoenix Suns, spoke to a group of students at Arizona State University and indicated that he disliked scalpers because "they made money off of him without his permission, and that was not right." He also did not want the problems associated with counterfeit seats sold by scalpers or fans being hassled coming to the game. Finally, he pointed to the fact that he paid taxes while scalpers did not.

The first legislative controls on unfair pricing practices were found in the Sherman and Clayton Acts (which in general terms controlled price fixing, tying contracts, etc.). The first legislation in the United States that focused specifically on ticket scalping appeared in 1918 in response to limited-access stage shows.[2] Then, with the rise in popularity of college football and major league baseball, large stadiums were built. Events like in-state rivalries and the World Series had fans lining up for blocks well before World War II.

The growth of population and per-capita income after World War II further intensified the demand for in-state rivalries, the World Series, and other such events. Accompanying this rise in popularity was an increase in season tickets. More season ticket holders means that fewer good seats are being sold on a per-game basis and that there are more event conflicts for consumers, resulting in a desire on their part to sell off tickets for certain games or shows. The impact is an increase in scalping along with more insider trading in which box-office employees take tickets (for good seats) and resell them at a substantial profit.

Regulation of ticket scalping has evolved and continues to be refined among the various states and municipalities. The first generation of anti-scalping statutes began by trying to curb the "small-time" activities of on-site scalpers. At both the state and local level, laws were passed to prohibit the resale of tickets above face value (with perhaps a nominal service fee), outlaw scalping on public property or within a certain distance of the event site, and require a license (see Table 1 for a listing of the types of anti-scalping regulations). A sizable number of statutes appear to have been passed to try to limit nuisance effects. But, in many cases, the effects went beyond on-site impacts, and in some instances, producers who were trying to protect profits played a prominent role in obtaining passage of regulations. All the early statutes made scalping a misdemeanor with fines, possible jail sentences, and confiscation.

The first generation of scalping laws continued as the primary form of regulation through the 1970s as legislative bodies tried to control

[2]People *ex rel.* Cort Theater Co. I.C. Thompson, 283 sel. 87, 119 N.E. 41 (1918).

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price, location, and nuisance effects. Changes in regulations included increasing fines and jail sentences, and some localities turned scalping into a felony rather than a misdemeanor. Yet enforcement of all types of regulations remained sporadic and arbitrary. Large numbers of police officers were needed at major events to round up on-site scalpers. But it was difficult to prosecute scalpers because most people purchasing tickets from scalpers saw no reason to testify against them.

Over the past decade a second generation of scalping laws has emerged that carefully segments scalpers on the street from ticket brokers or agents operating on the behalf of producers (see Table 2). Some states and municipalities have modified first-generation prohibitions and now permit licensed brokers to operate and to charge a price that reflects their cost of acquiring tickets. Some statutes have legalized producers giving permission to their selected agents to sell seats above face value and on site. The second generation of scalping laws has brought the resale market closer to a purely competitive situation.

Nevertheless, unregulated freelance scalping at the event is still illegal in most population centers. While enforcement remains

TABLE 2

SECOND GENERATION REGULATION: STATES AND MUNICIPALITIES PERMITTING RESALE

Form of Regulation	States Adopting[a]	Municipalities Adopting
Owner permission	Arizona, California, Connecticut, Kentucky, Michigan, Minnesota, Missouri, New Mexico, North Carolina	Ann Arbor, Atlanta, Detroit, Edmonton, Portland, Virginia Beach
Ticket brokers permitted	Florida, Illinois, Massachusetts, New Jersey	Baltimore, Calgary, Cincinnati, Milwaukee, Minneapolis, New York, Washington, D.C.

[a]The earliest of the second-generation regulations was that of Connecticut, passed in 1983. The remaining states passed their new forms of regulation after 1988, with the majority passing the changes in 1990 or later.

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sporadic and results in few convictions, there is something quite troublesome from a free-market perspective about restricting resale activities just before an event. The essence of the market for those types of limited-seating, one-time events is their here-and-now nature. The time when the greatest fluctuation in price is often most necessary is immediately before an event so that those who most want to attend and are most willing to pay can indeed get access.

Ticket Allocation Schemes

The most simplistic allocation scheme for an event is to have reserved seats go on sale at one box office location at one price starting on a given date. For example, in their national tour in 1989, the Rolling Stones charged the same price for all seats at all their concerts, and those seats were reserved. (If seats are not reserved seating, when purchased, then another line will develop at the time of the event as ticket holders jostle for the best seats; and given the safety difficulties with stampeding and trampling, most big time events have reserved seating.) Refinements on that scheme include having more than one box-office location and permitting phone orders in addition to on-site purchases.

Such an allocation scheme creates queues for major events. Scalpers or brokers will hire "diggers" or "droids" to stand in line or to make repeated phone calls to acquire tickets (Goodman 1991). Consumers who are fanatics or who have a relatively low opportunity cost of time will also be in line. Some will complain about scalpers or brokers squeezing them out of good seats even when restrictions are placed on the number of seats that can be purchased at one time. Some will also complain about related nuisance effects.[3]

Another refinement is to have consumers stand in line to draw a place in another line to buy tickets. Apparently, some producers feel that this scheme will minimize the time people must wait by sending signals about the actual chances of getting tickets. But it often increases the time involved because some people line up very early for the draw line even if the allocation of places is random.

Faced with frequent long lines, producers may charge different prices for various seat locations. One approach is to have two sets of prices; for example, one for general admission and one for select seating. Scalping may be moderated if good seats are priced considerably more than general admission, but it will still occur, and those

[3]Diggers or droids are frequently homeless people or substance abusers who may actually try to drive other people out of line when the number of tickets is restricted per box-office visit.

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who can afford to pay the most will often end up with the very best seats.

That last outcome appears especially troublesome to some performers. For example, Bruce Springsteen felt that many of his true fans were not able to attend his concerts in New Jersey because scalpers were driving up prices by using diggers and box-office insider trading to acquire tickets (Bershad and Ensor 1985). Of course, many of his true fans who originally purchased tickets engaged in scalping as the market price went up. The only sure way to guarantee that fans willing to endure a long wait get good seats and actually occupy those seats is to make them go into the event immediately after acquiring a ticket with no chance for a resale. For big events the lines may form days in advance, but ardent consumers will get the best seats.

Recently, the phenomenon of "scaling the house" has become more commonplace (Philips 1991). That pricing format is a method of price discrimination that charges a series of prices for different seat locations to increase profits and to fend off scalpers or brokers. One problem for the producer is to gather sufficient information about demand to charge the right prices. Another problem is that the better seats clearly will go to those with money.

A final scheme that avoids a precise knowledge of demand conditions for all seats at one time is a Dutch auction. That scheme begins by offering all seats at a very high price well in advance of the event and selling them first-come, first-served for a given time (say, a week). Prices then are lowered slightly, and this on-going price adjustment continues up to the time of the event. Scalpers will be present, but they will have to gauge the market more carefully than with one or two sets of prices. In such a setting scalpers may spend much of their time trading at prices below rather than above face value. The problem with the Dutch auction from the producer's perspective remains the public perception that only those who can afford to pay the most are getting into big events.

Future Generation of Scalping Laws

Several economic lessons are clear from our discussion of entertainment events and ticket sales. One is that continued trading of tickets is inevitable up to the time of the event, and so producers must live with the resale market. Another is that producers are often quite sensitive to certain consumers' perceptions of fair treatment in the marketplace. Finally, most producers and sizable numbers of consumers do not like scalpers. Even with the evolution toward legalized brokers and some on-site trading by permission of the producer,

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unrestricted scalping just prior to the event remains illegal in most locations.[4]

In this type of market, efficiency is sacrificed by regulation because information is being restricted at the very time it could be most beneficial. Consumers who have seats to sell are going to be reluctant to spend a great deal of time gathering price information for fear of legal reprisal. Thus they may sell to scalpers at below what the market is truly willing to bear. The scalpers then turn around and charge high prices to those seeking tickets.

Two points must be addressed before further suggestions are made. The first is whether the purchase of a ticket from a producer represents a licensed contract or a simple futures-like sale. Producers (like the Phoenix Suns) argue that the purchase of a season ticket is a license they have granted and can rescind any time the ticket is sold above face value. Their licensing interpretation serves to inhibit scalpers or brokers and keep them from buying tickets in large amounts for resale. The argument is rejected by market advocates and runs contrary to the notion that a ticket purchase is similar to going long in a futures market, where individuals are rewarded for buying low and selling high.

The second point focuses on the issue of just how much scalpers, through diggers and droids, drive up prices and squeeze true fans out of good seats. If there are some diggers and droids in line, then certain fans will not get the seats they would have preferred; and if the event is a sellout, the scalpers can command higher prices. However, if it is known that scalping activities are widespread and that diggers and droids will descend in mass, then consumers may simply wait to buy tickets. As long as one or few scalpers are not buying all the tickets, this postponement can actually lead to lower prices. Whether there are higher or lower prices depends on the scalpers' collective ability to read the market relative to the producer's ability.

With a desire for market clearing, we now turn to a third generation of scalping regulations. Instead of trying to restrict scalping activities, particularly at the time of an event, scalping activities should be encouraged by having vendors operate in designated areas in booths immediately next to the stadium or concert hall.

To understand the need for this form of market clearing, suppose there are no anti-scalping restrictions. What happens for a major event? Vendors on event day operate in the vicinity of the stadium or concert hall. In some cases the vendor locations may even develop

[4]The last time an anti-scalping ordinance was found unconstitutional was in 1973. See Estell *v.* Birmingham 286 So. 2d 872 (Ala. 1973).

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a sense of permanence, and some vendors may try to build a loyal clientele by establishing a company name.

A significant problem with this approach is the fragmentation of market information. Consumers must shop for price and will not be aware of all vendors in the market without extensive search. Also, there are the specific nuisance effects of people being hassled by scalpers either directly or by the traffic congestion that they can cause. Counterfeiting in such a fragmented market can become a major difficulty if scalpers are elusive.

A similar market-clearing scheme is found at Australian race tracks with touts or bookies. A consumer can place bets either with the track (the on-course totalizator) or with bookies who operate on site. The bookmakers must acquire a government license by paying a fee and undergoing background checks and verification of assets. The number of bookmakers on site may be substantial (25 or more), and they all operate in nearly identical booths. They post prices (odds) continuously, and unlike the track that pays out of the betting pool after the race is computed, bookies take bets at stated odds. Thus a potential wagerer can shop among bookies for the best odds or bet through the house, meaning arbitrage is on-going. At times bookmakers enjoy relatively large returns relative to the house, whereas at other times they suffer significant losses.

Similarly, concentrating scalpers in a designated area means those consumers who wish either to buy or to sell tickets have fewer search costs. Like the bookies, licensed scalpers or brokers could operate in booths. Depending on the broker, bid and ask prices may be posted for general locations (lower level, upper level, end zone), and they may be updated frequently. Two questions remain. What should the licensing requirements be and how are the booths to be allocated?

In licensing, one possibility is to require something analogous to the Australian tracks. Scalpers would have to pay a significant fee and go through detailed background checks. Such an approach makes it relatively easy to have scalpers operate in the designated area, because anyone caught selling tickets on game day outside the designated area would be arrested and fined or jailed, or both, with just cause. Market fragmentation is now minimized, as are nuisance effects. In addition, strict licensing discourages counterfeiting.

But, at the same time, strict licensing creates effective barriers to entry and the possibility of monopolies or cartels. As a result, we reject strict licensing and instead suggest having relatively minor licensing requirements. For example, anyone interested in buying or selling tickets from a booth would simply show valid identification to an

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enforcement agent. The license would pledge that the person will not trade counterfeit tickets and will quickly settle buyer or seller disputes.

The booths themselves could be auctioned off the day of the event, and the proceeds could be used in a public manner. In the process, economic profits are extracted from scalpers, which seems to make many people happy. However, bidding for booths may cause problems because the number of booths has to be limited to generate profits, and the profits become highly visible. If the profits from bidding fall into the public domain, there are all the attendant problems of disclosure of committee decisions, proper accounting, and the actual creation of public welfare. If the bids fall into the promoters' domain, the public sees conspiracy and insider trading. Only by having free access to the booths in the designated areas is the public generally assured of high degrees of competition.

Therefore, we propose that the booths be randomly assigned on event day at a prearranged time. The designated area needs to be large enough to accommodate a significant number of booths, preferably as many as there are licensed agents who want to trade. When assigned to a booth, an agent could be given special envelopes with the printed booth number to give out to buyers and sellers of tickets as the trades occur. In that way counterfeiting and other shady trading activities could be monitored.

Our proposal of nonrestrictive licensing and open access to booths likely would result in some traders continuing to have a presence in the market while others would be afforded the opportunity to enter markets for a limited number of events. Naturally, there will still be scalpers who will try to trade on street corners away from the designated area. While the police could do periodic sweeps to arrest them, we believe that most consumers would be reluctant to buy from them without the knowledge of the centralized market or for fear of receiving counterfeit tickets.

Similarly, there will be some people at the designated area who will try to sell tickets without a license. We believe that they should be allowed to operate, but consumers buying from them will clearly have no guarantees about counterfeit tickets. Whether there is a large or small number of licensed traders in booths in a particular designated area will depend on the pricing practices of licensed traders and on consumers' preferences for convenience or avoidance of shady trading practices.

Insider Trading

A final issue that must be addressed is insider trading. Public tolerance of scalping at the time of an event stems from the notion that

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anyone can stand in line (or pay others to do so), acquire tickets, and then charge what the market will bear. However, if the public perceives that promoters are controlling or rigging not only initial sales but also the resale market, or if box-office employees are in league with scalpers to acquire choice seats, reaction is likely to be strong.

The public's concept of a free market traditionally does not cover those who obtain access or information by means not available to everyone. An analogy is the harsh sanctions against insider trading in securities. Anyone can spend the time and money to research a security and the offering company, but not everyone would have access to a lawyer at a firm that handles the company's security offerings. Insider access is the line of demarcation for public policy in free-market regulation. Anyone can spend the time to stand in line for tickets or pay the funds to hire others to do so or run ads seeking tickets, but not everyone can gain access to a promoter or a box-office employee. Regulators thus must respond in some way to the public policy concern of the level playing field perceived to be lost if insider control of the secondary market is permitted.

With strict licensing, a possible means of control would be to require scalpers to disclose all ticket sources. In scalping, competitors and consumer groups might scrutinize sources. With minimal licensing and a large number of booths, as we have suggested, acquiring accurate disclosure forms from all vendors can be difficult. Actual control will depend on the extent to which local authorities are pressured by complaints of insider trading by box-office employees or by promoters. For some jurisdictions, the problem of perceived unfairness with insider trading may not be sufficiently compelling to require legislation or regulation.

Conclusion

Scalping is inevitable as long as there are advance ticket sales for big-time events and fan pressure to keep prices affordable to the general public. Our suggested legislative reforms recognize those market realities and push for legalized scalping at the event site. In most cases, the result of the reforms will be smaller economic profits for scalpers as competitive pressures and greater open-market access reduce the range between bid and ask prices. Through licensing, on-site nuisance effects would be restricted to a given area. Over time, the number of scalpers will be a function of the producer's ability to read the market at the time tickets go on sale and anticipate subsequent changes in consumer desires up to the time of the event.

Of course, many producers and certain consumers will resist the suggested changes. Consumers unwilling to pay higher than face-

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value prices will continue to complain about the inequities of the secondary market. That is the very time, however, that advocates of price adjustments as the best approach to scarcity must once again point to the folly of anti-scalping laws.

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Doing Well by Doing Good: A Market for Favors

K. K. Fung

Marian is a welfare mother with two preschool children. She works in a community daycare center taking care of her own and 10 other children. She does not get paid in cash. Instead, she earns six favor credits an hour from the center. She goes to classes two days a week to train as a nurse's aide. On those two days, she pays for day care with her favor credits. By the time she finishes training and gets a paid job, she will have accumulated enough favor credits for a year's day care.

John is a retiree on Social Security. He works in an after-school homework center in an elementary school. He also earns favor credits for his service as a tutor. He saves some of his credits to pay for future home care when his knees get too weak to walk. He uses some as partial payment for his vegetables from the neighborhood garden. He donates 10 percent of his credits to charities for a tax deduction toward his investment income.

Michael is an unemployed computer programmer receiving unemployment benefits. He is helping the senior center computerize its favor exchange database. For his service, he gets an office and access to various equipment, which he uses to facilitate his job search. He also earns favor credits for his service. He plans to donate most of them to obtain a tax deduction when he gets a paid job. Meanwhile, he uses some as partial payment for a membership in a health club that accepts favor credits as a cash discount.

Marian, John, and Michael are all residents of Favorville, FE. Favorville has a regular economy exactly like the one we find in every city in the United States. What makes it different from other cities

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is that it has a complementary "favor economy." In Favorville, transfer recipients like Marian, John, and Michael have an additional source of income besides transfer payments. They can work in the favor economy, earning favor credits to supplement their transfer checks without reducing their transfer benefits. And by helping to produce much needed services for themselves, they reduce the fiscal burden of their benefits on taxpayers. In addition, the danger of creating a stigmatized class forever dependent on transfers is reduced. By working in the favor economy, transfer recipients are learning skills that are marketable in the money economy when they are ready and paid jobs are available. Because welfare recipients are active in meaningful and productive activities, their self-esteem is maintained.

A Formal Favor Economy

Favorville, FE, does not exist. It is a conceptual formal favor economy in which people exchange favors using a means of exchange generally accepted in the favor economy. This means of exchange is a formal "favor credit" earned by performing services not for money but for return favors. Favors are returned when services produced by the formal favor economy are purchased with the favor credits. With the newly created opportunity to earn favor credits, those transfer recipients who choose to remain idle would incur the opportunity costs of forgone favor credits.

Members of close-knit groups have long exchanged favors informally. However, increased mobility has undermined those exchanges because there is no easy way to ensure return favors. Formal favor credits would overcome that problem, as favors done need not be returned by the same favor recipients. Instead, they can be returned by anyone willing to accept the formal favor credits. The generally acceptable formal favor credits can be used as full payment for other favor goods and services produced in the favor economy, or as partial payment for goods and services produced in the money economy.

Without a formal favor economy to facilitate favor exchanges, those who are not employed in the money economy rely increasingly on transfers from government in the form of public assistance or social insurance. Although the transfer economy cushions the money economy, it is an expensive buffer. The size of the transfer economy becomes a problem when it is larger than the working population can support. The subsidized leisure of nonworkers is particularly controversial when the services required to support them are increasingly expensive and much-needed services for the working poor go unprovided. A formal favor economy changes incentives by making transfer recipients more self-sufficient in these maintenance services.

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This paper explains how a formal favor economy might be established. In addition, it explores the micro and macro implications of a formal favor economy serving as a transition or buffer between the transfer economy and the money economy. The paper ends with a discussion of the many issues relating to the integration of the favor economy into the existing money economy and the voluntary sector.

To separate the money economy from the formal favor economy, I shall precede money-economy concepts with the words "money" or "paid." For example, a "paid input" is an input or resource purchased with money in the money economy, or a "money cost" refers to a cost payable in money. Similarly, favor-economy concepts are preceded with the word "favor." For example, a "favor input" is an input rewarded with favor credits only. And a "favor product" is a good or service made with a significant percentage of favor inputs by chosen "favor employers" who recruit favor inputs to work with paid inputs.

Why a Parallel Favor Economy?

In a market economy, not all of the human and material resources are or can be absorbed into the money economy. Even for those people who are actively seeking jobs, full employment is considered to have been reached when the unemployment rate is well above zero. For example, the U.S. labor force is said to be fully employed when the rate of unemployment is 5 to 6 percent. Although many factors lead to inactivity in the money economy, all inactive resources can be regarded as surplus in some sense to the money economy. At present, those resources are largely supported by transfer benefits. For example, over 50 million people in the United States receive either Aid to Families with Dependent Children (AFDC), Social Security, or unemployment benefits.

But the transfer economy is a very expensive and inflexible buffer for the money economy for the following reasons. First, transfer recipients need not perform any quid pro quo for their benefits. The one-way transfer encourages a sense of entitlement among transfer recipients. Second, transfer recipients are not allowed to engage in any meaningful gainful activity without jeopardizing their benefits. This restriction encourages idleness and reduces employability and self-esteem among transfer recipients. Third, transfer benefits make it financially feasible to live apart from close relatives. This possibility increases the transaction costs of intergenerational exchange of favors for Social Security recipients and teenage welfare mothers.

Reducing transfer benefits would force some of the transfer recipients back to the job market. But it is not clear that such a move would

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actually reduce the nation's poverty rate or improve the quality of its labor force.

Making transfer recipients active instead in the favor economy reduces money transfer benefits without reducing real benefits. If favor products are acceptable substitutes for paid products and if favor products can be produced with a substantial amount of favor inputs, the money costs to taxpayers of providing a given level of real transfer benefits would doubtlessly be reduced. Instead of providing transfer benefits in cash to be used to buy paid products, taxpayers would simply fund the paid inputs to work with favor inputs. The favor credits earned by the favor inputs then could be used to buy favor products.

Currently, transfer payments by all government levels are about 15 percent of GNP. If the formal favor economy can conservatively substitute 10 percent of the paid products purchased by the transfer economy with favor products, there will be a gross savings of some $90 billion. In other words, with the help of a formal favor economy, money transfer benefits can be reduced without a reduction in real benefits.

When transfer recipients can exchange favors in a formal favor economy, a more flexible and less expensive buffer between the money and the transfer economy is possible. This additional freedom comes from a new source of purchasing power that is acceptable primarily in the favor economy. Because of their restricted circulation, favor credits would not be counted as additional money earnings that would otherwise trigger a drastic reduction in transfer benefits. Favor credits would be taxed only by the formal favor economy and not be subject to government taxation as normal money income would be. This separation of favor credits from money offers other advantages than just reducing the money costs of transfer benefits.

First, favor credits earned by transfer recipients can be used to turn a one-way transfer of benefits from the government into a two-way exchange between money taxpayers and transfer recipients. That happens when taxes on favor credits payable to the formal favor economy are used to subsidize favor products purchased by low-income money taxpayers. For example, the transfers received by the elderly from the federal government are more than 10 times as much as transfers received by children under age 18 on a per capita basis (Richman 1992: 34). Even if it is collectively desirable to redistribute those benefits from the elderly to young children, it is politically difficult to do it directly by shifting money transfers. But, if the elderly provide child care and homework assistance for favor credits, the taxes

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they pay on the favor credits can be used by their favor employers to subsidize low-income users of the children-oriented services.

Second, funding paid inputs to work with favor inputs in the formal favor economy can channel surplus resources into producing much-needed services. If surplus resources are absorbed indiscriminately into the money economy, there is no assurance that they will be absorbed into sectors producing the much-needed services in short supply.

Third, the formal favor economy can reduce the money costs of moving working-age able bodied transfer recipients back to the money economy. For example, welfare mothers will go back to work sooner if child care is made more affordable by mobilizing surplus resources in the favor economy (Cattan 1991: 3–9). Because transfer benefits from the money economy would not be reduced by productive activity in the formal favor economy, the temporarily unemployed can maintain their self-esteem and employability by staying active. The same function can, of course, be achieved by creating subsidized or government jobs in the money economy. But if subsidized jobs are created in the private sector, there is no guarantee that those new jobs do not simply displace unsubsidized jobs. If government jobs are created to absorb the unemployed, the additional payrolls may simply add to the budget deficit unless the jobs produce enough tax revenue to cover the additional tax expenditure.

Thus, the formal favor economy is an important complement to the money economy. It will also reduce the harmful effects of the current transfer economy by transforming one-way transfers into two-way exchanges between money taxpayers and transfer recipients.

Service Deficit without a Formal Favor Economy

The more favor products can be made to replace paid products, the better the complementary role of the formal favor economy will be served. The favor products preferably should be those much needed by transfer recipients and yet too expensive to buy in sufficient quantity in their paid forms. Many of those products are labor-intensive services. Because labor productivity in commercial production of the services is not much higher than home production and the transfer economy is labor abundant, the formal favor economy enjoys a comparative advantage in producing such labor-intensive services.

Ironically, low labor productivity in commercial production of those much-needed services also explains why a serious deficit occurs in the services. If commercial production does not result in higher labor productivity, low-wage workers can ill afford to replace all the services

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they previously produced at home. The net gain from employment would be too small when other job-related costs are included if all the previously home-produced services are replaced.

A drop of home producers, therefore, means a service deficit. For example, rising labor-force participation among married women with children under age six from 18 percent in 1960 to 57 percent in 1988 (Fuchs and Reklis 1992: 42) has resulted in a deficit of parenting services (Garland 1989: 68). A 1989 survey conducted by Parents United for Child Care in Boston showed that 75 percent of working parents could not be home every day after school. Yet only 14 percent of the children were in any kind of formal after-school program each day. Nearly 50 percent of the working mothers in the survey claimed they could not call their children from work or receive calls from their kids, even in an emergency (Caminiti 1992: 53). A 1990 Urban Institute study reported that 12 percent of children between ages 5 and 12, the so-called "latchkey" kids, took care of themselves either before or after school.

The rising participation in the labor force of many full-time women homemakers who have traditionally performed community services has led to a deficit of community services. The shortage of community services can be gauged by the changing pattern of staffing in charitable organizations. As the supply of full-time female volunteers dwindles, leadership positions have been divided up. Copresidents and shorter terms have become more common. Inexperienced volunteers are tapped to fill once sought-after positions. Volunteers are offering smaller blocks of time and are more interested in short-term projects (Lombardi 1993: 1).

Some of the service deficits could have been offset by the rising population of retired persons. Between 1960 and 1990, the number of Americans ages 65 and above almost doubled, from 17 to 31 million (Fuchs and Reklis 1992: 41). But that age group, with the most leisure time, also had the lowest volunteer rate (1992 Independent Sector Survey). Not only were they not super-volunteers, they were also not super-grandparents. If they lived closer to their children and grandchildren, they could have replaced some of the personal services previously produced by nonworking mothers with young children. Financial independence made possible by Social Security benefits has encouraged many retirees to relocate far away from their children and grandchildren.

Even though retirees do not offer much help in reducing the service deficit of younger families, their failing health places a heavy burden on home health-care services. There is no evidence that Medicare or

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Medicaid can cover all the needed services or that the elderly are engaged in any significant amount of mutual help.

Establishing a Formal Favor Economy

Lowering Transaction Costs through Formal Favor Credits

The coexistence of substantial surplus resources and increasing service deficits would have promoted a thriving favor economy except for high transaction costs. Those transaction costs are related to the absence of a generally accepted means of exchange within the favor economy. Unless favor exchangers happen to have mutually coincident needs, favor-doers must accept informal favor credits. But because there is no fixed value to informal favor credits, they are not generally acceptable. And because informal favor credits are seldom recorded in writing, they are not easily carried into the distant future. Not surprisingly, favor exchanges are mostly conducted among members of close-knit groups to reduce transaction costs (Fung 1991: 450).

The transaction costs would increase if members of an otherwise close-knit group became more mobile and separated over greater distances. Americans are well known for their mobility. An average American family changes residences once every seven years. One contributing factor is the availability of third-party retirement funding, which enables retirees to relocate to distant retirement communities. Mobility trends have no doubt increased the transaction costs of informal favor exchanges. Data from the 1987–88 National Surveys of Families and Households not surprisingly showed that adults living within 10 miles of their aging parents were 50 percent more likely to exchange intergenerational support (Hogan, Eggebeen, and Clogg 1993: 1444).

With computerization, favor credits could be formally recorded, and matching of needs could be more easily coordinated. But, without a generally accepted means of exchange within the favor economy, favor credits and debits still cannot be easily settled. Just as market exchanges cannot function properly without money, favor exchanges cannot function properly without formal favor credits. Mere tabulations of supply and demand for favors in incommensurable physical units without the mediation of prices cannot lead to efficient settlements. What can be done to lower transaction costs of favor exchanges, given the high mobility of potential favor exchangers? The answer lies in establishing a system of generally acceptable favor credits.

Favor credits become a generally accepted means of exchange in the favor economy when they are a generally accepted means of storing value in the favor economy. And they become a means of

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storing value when their issue is controlled and favor products are priced in terms of favor credits.

When formal favor credits are given for favors done, there is no longer a need to barter for favor exchanges. Recipients of favors do not have to be the parties who return the favors. If favor credits are stored on a debit card, for example, there should be no geographic restriction to their acceptability. Favors can be done in one place and the favor credits earned can be spent in another. Mobility and physical distance need not be barriers against favor exchanges. Favor credits can just as easily be transferred from one person to another as donated to one's favorite charities.

Thus, the ability to earn formal credits for doing favors means that the extent of favor exchanges need not be limited by inadequate generosity. Because favor credits can be used to secure desired favors, self-interest alone would go a long way toward expanding the favor economy.

Who May Earn Favor Credits?

There is no reason why the formal favor economy should be limited to transfer recipients. Other people who are not transfer recipients and would have volunteered their services to charitable organizations may find the formal favor economy an attractive way to offer their services for favor credits. For example, school-age children and other people who do not have a substantial amount of leisure time may be encouraged to work in the formal favor economy by the reward of formal favor credits.

Setting Favor Credits

How many favor credits should favor-doers be paid when they offer their services as favor inputs? To achieve seamless integration with the money economy, favor inputs should be priced the same as their money-economy equivalents. For example, if day-care attendants in the money economy are paid $5 an hour, those who perform day care of equivalent quality in the favor economy will be awarded five favor-credit dollars.

There may be some ideological objections to transferring all the market imperfections from the money economy to the formal favor economy by adopting the same prices. Indeed, some service credit programs that facilitate service exchanges among their members give one service credit for one hour's service regardless of skills and experience involved (Cahn and Rowe 1992). While this egalitarian arrangement is morally satisfying and workable on a small scale, uniform pricing of time deprives the favor economy of the means to eliminate

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shortages and surpluses of favor inputs. Paying scarce inputs the same as abundant inputs would only perpetuate shortages because there is no incentive to increase the quantity of scarce inputs supplied.

Tying favor-credit dollars to money dollars lends instant credibility to favor credits as a means of exchange. In addition, such market-based favor credits offer the following operational advantages:

1. Market-based favor credits make it easy for funding agencies to compare the efficiency of different favor employers. For example, favor employers need full-time paid labor to supervise and work with mostly part-time favor labor to produce favor products. The more favor inputs they can recruit, the fewer paid inputs they need to buy. The fewer paid inputs they have to buy to work with favor inputs, the greater the leverage effect per unit of money dollars. And the more productively the inputs (paid and favor) are managed, the lower the total (favor and money) costs for a given amount of favor products. Thus, when paid and favor inputs are priced competitively, the efficiency of different employers can be compared directly. That is, the larger the total (favor and money) costs and the higher the proportion of paid inputs for a given amount of favor products, the less efficient the favor employer must be. A given amount of funding for paid inputs can lead to more favor products if the more efficient favor employers are funded.
2. Market-based favor credits also make it easy for favor-doers to verify whether they have been rewarded fairly and for favor employers to price their products competitively in terms of favor credits.
3. The return of the temporarily unemployed to the money economy will be easier if they are aware of the market wages of money-economy jobs through the competitively priced favor-economy jobs. By working for the highest favor credits per hour, they are automatically honing the same skills that also command higher pay in the money economy.

Controlling the Issue of Favor Credits

Because the favor economy is intended to supplement the money economy, favor credits should be issued only by employers who are willing to accept favor credits as primary payments for their products or give a money price discount to low-income users who cannot otherwise afford their services. Those employers may be nonprofit operators who mostly use favor inputs but rely on government or charitable funding for their paid inputs. Or they may be for-profit

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operators who use some favor inputs, but rely on their own funding for their mostly paid inputs.

The total amount of favor credits to be issued is determined by the total value of favor inputs the chosen favor employers have committed to hire after their proposed budgets are accepted by agencies that fund paid inputs. Favor employers will retain their power to issue favor credits only if they deliver to users the proposed amount of favor products at specified prices within the budgeted amount of favor credits.

Favor credits will be recycled to favor employers who issue them when their favor products are sold to users who pay with favor credits to partly or fully cover their favor costs. If favor employers sell the whole output of favor products at the specified prices, they should be able to recoup the same amount of favor credits (or their money equivalent) that they started with.

What Are Favor Credits Good For?

Favor credits could be used for favor products produced in the favor economy. The products can range from day care and home health care to vegetables from neighborhood gardens. Favor credits could also be used as full or partial payments for paid products. For example, businesses can run sales promotions by offering a money price discount to customers who can make up the difference between the full cash price and the discounted price with favor credits. Colleges may even accept favor credits as partial payment for tuition and trade the favor credits for money.

In addition, favor credits could be saved and deposited in favor-credit banks for future use. The savings then could be loaned to those who do not have enough favor credits to buy the favor products they need now. Part of the interest the borrowers pay will go to reward the savers. Making loans with savings will ensure that there is enough purchasing power to buy all the favor products at prices sufficient to cover the favor costs.

Redistribution of Favor Credits through Taxation and Donations

With the current method of volunteer services, volunteers commit to a one-way transfer of services to the needy. There are no favor credits in return for their services. In the formal favor economy, however, favors are rewarded with formal favor credits. If favor credits are not taxed or donated, the formal favor economy will serve only to exchange favors among favor doers. When favor credits are taxed or donated, the taxed or donated credits can be used to subsidize favor products for low-income users.

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To encourage donations of favor credits, money tax deduction for donated credits should be considered by the Internal Revenue Service. Currently, tax deductions are allowed by the IRS for donations of material goods only. If this practice continues after the formal favor economy is established, then donations of favor credits earned from offering material goods will be tax deductible but donations of favor credits earned from offering time will not be. Such an anomaly can be eliminated if all donations of favor credits are made tax deductible.

How Should Favor Products Be Priced?

Because all favor inputs are paid in favor credits at the same rate as equivalent paid inputs, favor products should be priced at the same rate as equivalent paid products. Pricing favor products at the same rate as paid products ensures that the formal favor economy is at least as efficient as the money economy. It also ensures that those who pay with money would enjoy no price discount if they chose to buy favor products instead of paid products.

The prices actually paid would vary depending on the forms of payment and the income status of users:

1. Low-income users who do not have favor credits will pay a money price equal to part of the paid costs plus part of the favor costs. The percentages would be determined by how much of the money costs come from renewable subsidies and how much of the favor costs are covered by favor-credit donations and favor-credit taxes. The higher the share of money costs funded by renewable subsidies and the higher the share of favor costs covered by favor-credit donations and favor-credit income taxes, the lower the money prices will be for those low-income users.
2. Low-income users who pay primarily with favor credits will pay favor credits to cover the full favor costs and money to cover that part of the money costs not funded by renewable subsidies.
3. High-income users who may or may not have favor credits will pay the same prices for favor products in money or in favor credits as the money prices of money-economy equivalent products. This competitive pricing for high-income users ensures that the formal favor economy will not compete with the money economy.

Pricing favor products competitively with equivalent paid products should recover all the favor costs and the money costs not funded by renewable subsidies if the mix of favor products is exactly what the users want and the users spend a mix of money and favor credits equal to the mix of money costs and favor costs.

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But, if users spend more money than favor credits to buy favor products, favor employers will receive more money than is needed to recover fully the nonsubsidized money costs. And the demand from those who use mainly favor credits will not be fully met. The resulting shortage of favor products will signal the employers to produce more favor products. The extra money income can be used then in the next period to hire more paid inputs that will work with more favor inputs to produce more favor products. On the other hand, if favor products are left unsold, neither the money costs nor the favor costs of those unsold favor products will be covered. The resulting surplus of favor products will signal the employers to produce less of the favor products.

In general, shortage and surplus of favor products, rather than their prices, will be used to regulate supply. The prices of favor products will rise or fall only in response to the costs of paid inputs and favor inputs and the money prices of equivalent paid products.

Trading Favor Credits for Money?

Such a clean separation between money and favor credits, as payments for favor products, is possible only if exchange between them is forbidden. Attempts to separate money from other means of payments have not been entirely successful. For example, some food-stamp recipients sell their food stamps for money to buy nonfood items that cannot be purchased with food stamps. The illegal use of food stamps effectively defeats the purpose of providing affordable food items to low-income families. Might not favor credits be traded illegally for money to buy paid products?

The incentives to trade favor credits for money certainly exist. First, because earned favor credits are not subject to IRS taxation or taken into account for computing transfer benefits, favor credits converted into money can be concealed easily from the IRS and transfer-benefit agencies. Thus, earning favor credits is a convenient way to avoid paying the exorbitant net marginal tax rate (Laffer 1984) transfer recipients are subject to when they openly earn money through paid work. Second, money can buy all paid products while favor credits are good mostly for favor products.

There are also incentives to trade money for favor credits. If favor credits can be bought with money at, say, 50 percent of their face value, they can be used to buy favor products at half their cash price. But if favor credits are embodied in debit cards and not in denominated bills, favor credits cannot be transferred easily to others without giving up the card itself. Trading favor credits for money through electronic transfers is of course possible. But such transactions leave easily detectable traces and are usually avoided in illegal transactions.

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Nationwide and Communitywide Administrative Structures

To run the favor economy, some nationwide and communitywide administrative structures are needed. The most important component of the nationwide administrative structure is the favor-credit banking system. A banking system is needed to accept deposits and make loans, to clear transactions between favor-credit accounts, and to issue favor-credit debit cards. The tendency toward inflation by awarding too many credits is controlled by the funding for paid inputs and the prices of money-economy equivalents of favor inputs. The funding for paid inputs determines how many paid inputs can be hired to work with the favor inputs. And the prices of money-economy equivalents of favor inputs determine how many favor credits should be issued. The most important job of communitywide administration structures is to determine what favor products to provide and their priorities in the allocation of funding for paid inputs.

In addition, the administrative structures should be responsible for (a) collecting taxes on favor-credit income and accepting donations of favor credits; (b) distributing favor-credit taxes and donations to favor employers according to the same priorities governing the allocation of funding; (c) soliciting funds from the money economy; (d) dealing with publicity, recruitment, interviewing, referral, orientation, training, and liability insurance (Chapin 1977); and (e) making routine and long-term policies for the favor economy. As nationwide and communitywide administrative services are shared, contributions of funds to their providers should be prorated to individual favor employers by the number of favor credits issued.

Sources of Funding

All the paid inputs needed to staff these administrative structures and produce favor products must be paid in money dollars if surplus resources are to be mobilized in the formal favor economy. Such funding can come from revenues from the sale of favor products (i.e., that part of the payments for favor products in the form of money rather than favor credits) and from redirected government or charitable funding.

Redirected government or charitable funding is the part of funding previously used to buy paid products that is redirected to fund paid inputs to work with favor inputs to produce favor products. For example, a board of education may use part of its budget for reducing class size to fund on-site after-school homework centers staffed partly by favor-doers. Or a Medicaid waiver program may channel part of the budget for institutional care to fund home care partly staffed by favor-doers. Or government funds intended for subsidized paid jobs in the

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private or government sector can be diverted to the favor economy to create a lot more favor jobs. Although these specific funds probably cannot be diverted to fund services in other programs, part of them can be used to fund the core administrative infrastructure for all favor exchanges.

Allocation of Funding

How should funding for paid inputs be allocated among different favor products? Three levels of decisions must be made.

First, favor products could be prioritized through citizen surveys or a representative political process in each community. That regional approach allows the list to vary according to local needs.

Second, given the list of priorities, favor employers in each category of favor product will be selected through competitive bidding. Employers that can provide a given amount of favor product at the lowest total (favor and money) cost with the highest component of favor inputs will be funded. That selection criterion ensures that the limited funds have the maximum potential in mobilizing surplus resources.

Third, once the budget proposals of potential favor employers are examined, funds can be allocated to the most efficient favor employers in light of the priorities given to different favor products.

Who May Apply for Funding?

The primary recipients of funding for paid inputs should be those nonprofit favor employers who accept primarily favor credits for payments or offer money price discounts to low-income users. Although for-profit employers should be allowed to issue favor credits if they are efficient producers of favor products and are willing to lower prices to low-income users, they should not be eligible for funding unless there are no nonprofit employers.

Anticipated Objections

Can Benefits Justify Costs?

Promoting favor exchanges among favor-doers with surplus resources is a romantic idea that can readily appeal to many people. But their enthusiasm quickly wanes when they realize that a formal favor economy requires its own infrastructure and regulations to run smoothly. They wonder if the infrastructural costs of a formal favor economy might not eat up most of the benefits of formal favor exchanges.

Even though favor inputs need not be paid in money, they are still priced in terms of favor credits at the same rate as equivalent paid

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inputs. If the infrastructural costs of the formal favor economy are so high that favor products must be priced above their equivalent paid products to cover their paid and favor costs, favor products would not be competitive with paid products. But as long as the infrastructural costs of the formal favor economy are comparable to those for the money economy, the fact that a parallel infrastructure must be set up should not lead us to question the cost effectiveness of the formal favor economy.

There are reasons to believe that the average infrastructural costs per favor exchange are comparable to those for paid exchanges.

First, there are substantial economies of scale resulting from the large number of transfer recipients. For example, the number of food-stamp and Social Security recipients alone amounts to some 60 million people. A favor economy serving that many people is much larger than some independent money economies in the real world. If those money economies can afford their exchange infrastructures, a formal favor economy in the United States can surely afford its own favor exchange infrastructures.

Second, existing transfer agencies can perform most of the functions required by the formal favor economy. For example, the food-stamp administration, which is in the process of replacing food-stamp bills with debit cards, can also handle the issue of debit cards for favor credits. The Medicaid administration can select favor employers to provide favor home-care by setting aside some funds originally intended for paid home-care. Local boards of education can similarly select favor employers to provide after-school on-campus tutorial day care by setting aside funds originally intended for more paid teachers to reduce class size.

Third, the marginal real costs of some favor inputs may be close to zero because they have no alternative uses. In other words, some favor inputs need not be paid any favor credits at all because there is no demand for equivalent paid inputs. For example, older computers that are too slow for the money economy need only be paid favor credits equal to the salvage values of their constituent materials. But they may still be fast enough to service the favor-credit banks.

With all those cost advantages, the infrastructural costs of the formal favor economy should be manageable. In addition, because favor employers are selected on the basis of cost efficiency, favor products should be competitive with paid products.

Does the Formal Favor Economy Really Exchange Favors?

Because informal favors create a sense of indebtedness in the recipients that motivates reciprocity, favor exchanges are usually regarded

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as socially integrative. The integrative power is believed to be stronger if the favors are done unconditionally or if the indebtedness is not fully discharged (Boulding 1973: 15–34). It seems to follow that if favors are rewarded in full with market-based favor credits in the formal favor economy, favors no longer serve any integrative functions. Instead, favor exchanges would be no different than market exchanges in the money economy.

Such a conclusion is unwarranted because it overlooks the important role the formal favor economy can play in promoting reciprocity from transfer recipients to money taxpayers. Because transfers are presently handed out as collective favors from taxpayers by impersonal bureaucratic agencies, transfer recipients do not feel obligated to return those favors. Instead, they regard such transfers as their rights. Whether the transfers impose excessive burden on taxpayers is the last thing on their mind. Unless their subsidized leisure is looped back to the pocketbooks of taxpayers, transfers will remain a purely coercive obligation of taxpayers. When transfer recipients start paying taxes on or donate the favor credits they earn in the formal favor economy, they will be able to return favors to low-income taxpayers in the form of subsidized favor products. When transfer recipients can exchange favors among themselves and when they maintain their employability in the money economy by staying active in the formal favor economy, they are returning favors to money taxpayers by reducing the fiscal burden of their transfer benefits.

The formal favor economy is not intended as a substitute for informal favor exchanges between acquaintances who interact on a regular basis. Such informal favor exchanges will still be conducted without any formal favor credits because formal favor credits can be issued only by approved favor employers and not by individual favor recipients. Rather, the formal favor economy is simply a means to reduce the high transactions costs of exchanging mutual help between large groups of strangers outside the money economy.

The Formal Favor Economy and the Nonprofit Sector

Together with the government transfer economy, the nonprofit charitable sector has long served to buffer fluctuations of the money economy. It is where volunteer labor and nonlabor donations have concentrated (Weisbrod 1988: chaps. 5 and 7). The introduction of a formal favor economy will provide a formidable competitor for the nonprofit sector because it offers formal favor credits to surplus resources that it employs and price discounts to low-income users of favor products.

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However, it does not mean existing nonprofits would be entirely displaced. On the contrary, existing nonprofits could continue to operate provided that they meet the efficiency requirements of the funding agencies. Economic efficiency requires that only those nonprofits that have the lowest overall budget using the largest percentage of favor inputs for a given amount of favor products would be funded for their paid inputs. Even if an existing nonprofit is not funded for its paid inputs, it can still continue to issue favor credits for the surplus resources it employs provided that its favor-product prices are competitive with those nonprofits that are funded for their paid inputs and its products fall within the community-determined priority list.

Because funding for favor employers must be subject to popularly determined priorities, some nonprofits that pursue narrowly defined objectives will not be funded nor be allowed to issue formal favor credits for surplus resources they may still be able to attract.

Thus, the superimposition of the formal favor economy on the nonprofit sector will have an efficiency-enhancing effect on the management of nonprofits and ensure that any operating surplus will not be dissipated for unintended purposes but must benefit users of favor products in the form of lower (cash plus favor credit) prices.

Is the Favor Economy a Complement to or a Competitor with the Money Economy?

Because the formal favor economy promises to produce favor products that are substitutes for similar paid products, it could potentially affect the money economy in the following ways: (a) For-profit employers may substitute favor inputs for paid inputs, (b) non-transfer recipients and high-income users may substitute favor products for paid products, (c) favor employers may squeeze out paid employers, and (d) favor products may squeeze out paid products.

Substitution of Favor Inputs for Paid Inputs? If favor inputs need not be paid money wages, may employers substitute favor inputs for paid inputs to increase profits? When that happens, the demand for paid inputs and hence their money prices will be depressed. But it happens only if the cost savings from favor inputs can be kept by for-profit employers. If employers must charge high-income users the full costs of paid and unpaid inputs and channel the cost savings only to those who cannot afford the full price, there is no profit motive for employers to substitute favor inputs for paid inputs.

For nonprofit employers, if money cost savings cannot be transferred to other uses, the substitution of favor inputs for paid inputs (after funding for a given amount of paid inputs has been approved) would not bring them any benefit.

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Leakage of Favor Products? Although favor products are less expensive in money terms for low-income users and favor-doers, there is no price advantage for high-income users. For them, favor products cost the same in money terms as paid products.

Unfair Competition to Paid Products? Given a fixed amount of transfer benefits, favor products can be produced only if some of the funds are diverted from paid products to hire paid inputs to work with favor inputs. With the fund diversion, more products are available. But the absolute output of equivalent paid products will be lower and the paid inputs otherwise used by paid employers will be used by favor employers instead.

With growing transfer benefits and only a partial diversion of the funds to hire paid inputs in the formal favor economy, output can grow of both paid products and equivalent favor products. Employment of paid inputs can also increase in both economies. That is especially true when paid products are too expensive to meet the needs of transfer recipients and low-income users. Given such an elastic demand, a controlled growth of favor products at lower money costs would only reduce the unsatisfied needs and not divert absolute demand from equivalent paid products.

Conclusion

The transfer economy supports surplus resources that could not be easily integrated into the money economy. The size of the transfer economy is particularly controversial when the services required to support its members are increasingly expensive and much-needed services for the working poor go unprovided. The fiscal burden on taxpayers to support the transfer economy can be greatly reduced and transfer benefits can be more evenly redistributed if the surplus resources are mobilized to produce many of these services for return favors instead of money. The transaction costs of the favor exchanges can be reduced greatly if formal favor credits are created. With favor credits as a generally accepted means of exchange within the favor economy, favor exchanges will no longer be limited by inadequate generosity, mobility, and physical distance among potential favor exchangers.

In addition to providing valuable services at little money costs, the favor economy can effectively buffer fluctuations in the money economy. By working in the favor economy, transfer recipients can maintain their self-esteem and learn new skills that could be transferred to the money economy when the individuals are ready and paid jobs are available.

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By pricing favor inputs according to their money-economy equivalents, funding agencies can easily compare the cost effectiveness of different favor employers. This ability should impose a much-needed efficiency discipline on the nonprofit sector, which has been a major user of favor inputs.

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Payments Technologies, Financial Innovation, and Laissez-Faire Banking

F. X. Browne and David Cronin

The last decade has seen a renaissance of interest in the idea of laissez-faire banking. This is an arrangement whereby the government practices a policy of laissez-faire in relation to the medium of exchange and the banking and financial system.[1] Proponents of this form of banking argue that it would be inherently stable and, accordingly, there would be no need for the type of elaborate regulatory structure which is in place to act as a safety net for current banking arrangements. The systemic health of laissez-faire banking would be assured by a stable payments system, an efficient intermediation of funds, and restraints on the growth of base money.

The laissez-faire banking literature tends to focus on banks issuing traditional notes and coin (the "new monetary economics" [NME] school being an exception) for several reasons. First, this approach seems the most straightforward way of thinking of private substitutes for government-issued paper money. Second, it supplies a useful framework for reexamining history. Third, it avoids the need to speculate about future technological developments. On the other hand, consideration of recent technological developments should not be neglected as they may eventually render paper currency completely unnecessary, thereby offering an alternative path to a depoliticized (or purely private) payments system. We believe that research on

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[1]Lawrence H. White (1993) and George Selgin and White (1994) provide thorough reviews of all aspects of laissez-faire banking.

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laissez-faire banking should give greater attention to the potential implications of rapidly improving technology in electronic payment instruments (based on integrated circuit/smart cards and advances in telecommunications) which are being developed by private sector banks. In this paper, we attempt to consider what banking system might emerge from these advances in "electronic money" (and advances in financial markets, in particular securitization). We conclude that those technologies may be enhancing the prospects of laissez-faire banking emerging (endogenously) over time.

As argued later, electronic money, when developed to its full potential, will have clear pecuniary and nonpecuniary advantages over government-issued currency. It is difficult to envisage how notes and coin could undergo a technological advance as payments media that would enable them to compete with electronic money. Accordingly, outside money may suffer a substantial decline or even disappear as a transactions medium in the long run with seigniorage passing to the private sector in the form of a cheaper and more efficient payments system unless these competitive advantages were somehow countered by central banks.[2] It would appear difficult for central banks to compete in providing electronic money. Electronic payments technology is already well-disbursed among private institutions. Accordingly, there would be little public support for a central bank putting in place its own retail electronic payment infrastructure, at great expense to the taxpayer, for charging and recharging cards with an existing private infrastructure already in place. Alternatively, the central bank commandeering the private network would also be likely to prove unpopular with private agents, given its cost to them as both taxpayers and consumers of electronic payment services.[3] Finally, central banks would have to hold retail deposit accounts from which cards' purchasing power would be drawn down, an area in which they have little experience or expertise.

In endeavoring to understand future developments in payments systems and financial markets, the evolutionary approach to the development of money, which has long been propounded by the Austrian school (see Menger [1871] 1981 and von Mises [1912] 1971), would seem best suited. In our view, the movement to a situation where the asset that acts as the medium of account (outside money) is not

[2]The incentive to capture seigniorage should prove sufficient for the private sector to develop electronic money to exploit to the full its pecuniary and nonpecuniary advantages over traditional notes and coin.

[3]A monopolization of a competitive banking system's electronic payments infrastructure could diminish the prospects of interest being paid on electronic money balances and give rise to higher per-item transaction costs than the competitive charge.

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itself used as a medium of exchange, even in interbank payments, conforms to this evolutionary approach to money and would seem to be the preferable route to a much more efficient cashless economy. Indeed, it may be preferable to the widely canvassed alternative route to laissez-faire banking that advocates deregulation to end the government's involvement in banking and the payments system for at least two reasons. First, the evolutionary route would not undermine confidence in existing payments media which is a pivotal element in Austrian monetary theory (Cowen and Kroszner 1987). Second, outside money's role as a unit of account is much less likely to be jeopardized as it surely would be by the sudden departure of government-backed currency as a medium of exchange.

The Evolutionary Route to Laissez-Faire Banking: Electronic Money and Share Banking

Electronic Money

For large-value transactions, the medium of exchange and store of value roles of government-backed currency have long been dominated by other privately provided transactions instruments such as interest-earning bank deposits subject to check (for example, Negotiable Order of Withdrawal or NOW accounts in the United States). For small-value transactions, which still comprise the vast bulk of all transactions but only a small fraction of their total value, currency is still the dominant transactions medium. Two types of electronically activated payments cards—debit cards and prepaid cards—have been designed to accommodate small-value payments and have recently become commercially available. Debit cards are operated on-line to the holder's bank account. At a point of sale the card is swiped through an electronic funds terminal which activates a signal to the card holder's bank to transfer the specified payment amount from the card holder's bank account to that of the payee. Prepaid cards are cards that have embedded value that can be used to purchase goods and services until the stored value is exhausted. The embedded purchasing power is drawn down at the point of sale by an electronic device that can suitably adjust the information on the card. The amount of stored value remaining on the card can be made visible at any time. While initially popular for single-item purchases, multipurpose prepaid cards are now becoming available and can be used indiscriminately for any small-value purchase. Whereas debit cards are on-line to the holder's bank, prepaid cards are typically an off-line method of payment, the card either being disposed of when the stored purchasing power is spent or alternatively reloaded by insertion in a terminal.

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Improvements in card technology would not be particularly valuable without reader technology at points of sale. This service is provided by Electronic Funds Transfer at Point of Sale (EFTPOS) technologies which continue to improve. In particular, recent advances in the communications technology based on fiber-optic cables and digitalization of information hold the promise of an efficient high-speed communications network for the whole economy. The principal benefit for payment systems is that on-line card transactions costs are likely to fall to negligible levels. EFT computer terminals and home-based "dispensing" terminals seem likely to be linked to bank accounts by fiber-optic lines and data transmission to be carried by light through optic fibers. This system is more powerful than transmission by copper wire or by radio frequencies and potentially very cost-efficient, given a recent development that obviates the need to convert light signals into electronic signals and back again every 22 kilometers. In conjunction with payment card developments, it should be possible to effect an immediate deduction of the amount of a purchase from the purchaser's bank account and transfer it to the bank account of the vendor via EFT at a negligible cost.

The advantages of electronic money over a paper-based retail payments system are numerous. For banks, electronic money promises to be very cost efficient in comparison to prevailing paper-based payment systems. A switch from paper to electronic money is likely to cut deep inroads into bank costs, particularly labor costs, of routine processing of currency and paper-based payment instruments. Retailers would not have to carry or handle large physical sums of money, which would also reduce their costs and susceptibility to theft.

Developed to its full potential, consumers will find that electronic money has distinct nonpecuniary and pecuniary advantages over currency. Cards are easier to carry and, since they do not circulate, possibly cleaner; they also offer greater security for the card holder since their embedded value cannot be drawn down manually. Of possibly far greater consequence, however, is the potential pecuniary advantage to card holders of earning interest on their electronic money balances. The logistics of the issuer paying interest on the unspent balances on prepaid cards are simple. When a financial institution issues a card it obtains a float of funds from the purchaser. Since value is drawn down at an electronic terminal it would be straightforward to pay interest on each increment of embedded value in the card up to the time each is spent. The payment of interest on debit cards is even more straightforward, being tantamount to permitting debit cards to be charged against an interest-bearing account held at the issuer's bank. Both the pecuniary and nonpecuniary advantages of electronic

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money for consumers and the significant cost savings to banks are likely over time to erode the role of currency in retail payments.[4]

The Stability of Laissez-Faire Banking with Electronic Money

One of the arguments against private banks issuing their own notes and coin, a defining characteristic of most versions of laissez-faire banking, is that they would engage in overissue, possibly leading to hyperinflation. Proponents of laissez-faire banking like White (1984a), Selgin (1988), David Glasner (1989), and Kevin Dowd (1993) would reject this by arguing that if an excess supply of banknotes existed then the amount representing excess real balances would be promptly returned to the issuer. This view is supported, in particular, by Selgin's (1988) evidence that historical unregulated banking systems were characterized by a short issue-redemption lag. Therefore, since issuing banks must stand ready to honor the claims against them, they would be clearly reluctant to engage in overissue (the principle of adverse clearing).

We can see two ways in which electronic money could impart even greater stability to laissez-faire banking. They both revolve around one of the basic features of electronic money, namely (subject to some caveats, see below) that it does not circulate. This, as already argued, would enable interest to be paid on electronic money. Competition would force banks to pay interest at the rate that the bank earns on its assets less some small competitively determined margin for the cost of banking services. In order to induce the public to hold more electronic money (prepaid, debit or smart card purchasing power) banks would have to offer higher interest at the margin. But they could not offer a higher rate than that which they could obtain on their assets. This condition would clearly lessen any incentive to overissue. Second, since electronic money does not generally circulate and constitutes an immediate claim on the issuing institution as soon as it is first spent, the mechanism of adverse clearing would operate even

[4]Although currency has declined in importance relative to other monies over time, the amount of currency outside banks continues to rise in absolute terms. The large-value counterparts (direct debits, standing orders, paperless credit transfers, etc.) to small-value retail electronic payment media have been widely available to households and firms for 10 or more years. Cronin (1994: 27–30) finds evidence of a direct replacement of those larger-value instruments for their paper-based counterparts in recent years in four EU countries (France, Denmark, the Netherlands, and Spain), which are relatively advanced in the use of these electronic payment media. In all four countries, there has been both an absolute and relative decline in the volume of cashless paper-based transactions. It is not, therefore, inconceivable that, at the small-value retail level, smart cards and prepaid cards, once they leave their present gestation/pre-saturation stage of development, should begin to reduce the absolute demand for currency as a transaction medium.

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more promptly than in a system based on circulating banknotes. Selgin (1988: 148) reports that in Scotland in 1873 the average period of circulation of a bank note was only 10 to 11 days, a delay that is hardly long enough to encourage banks to overissue. The delay is likely to be shorter for electronic money. For commercial transactions effected by debit cards, for instance, there is no issue-redemption lag as electronic money will remain at the issuer's bank account until it is transferred instantaneously on the making of a payment instruction at a point-of-sale. Similarly, interpersonal payment transfers via debit card would also be effected quickly.

With regard to prepaid cards, one would expect electronic money balances drawn down onto such a card at a loading terminal to remain on the person of the withdrawer for the same length of time, ceteris paribus, as paper currency drawn down from an ATM. Once spent, at a point-of-sale, however, electronic technology would ensure that the electronic money claim would be more quickly returned to the originating bank than the relatively cumbersome paper money claim. The relative ease with which claims accumulated by merchants could be downloaded and credited electronically to bank accounts via a terminal located at the site of business, compared with a time-consuming visit to a bank branch by the payee, would be an important feature reinforcing the discipline of adverse clearing. A similar situation would most likely hold for interpersonal payments made by prepaid cards. At the personal level, however, this argument has to be balanced against the fact that electronic money does not depreciate physically (unlike banknotes) and could therefore remain outstanding for longer durations of time, particularly if intercard transfers can be effected smoothly (and it appears that more advanced cards, e.g., National Westminster Bank's *Mondex* Card, possess this feature). Nevertheless, interpersonal transfers effected by prepaid cards are likely to constitute only a small fraction of total electronic payments and, thus, do not strongly detract from our general argument. Electronic money would underpin the stability of a banking system based on private unregulated banks. On the face of it, electronic money would assist in both establishing and maintaining a stable laissez-faire based monetary system.

Share Banking

There is yet another aspect of the shape of banking in the future that, if realized, would also support its inherent stability in the absence of government intervention and which, in conjunction with the electronic payments technology outlined above, could realize a payments system most closely approximated by the NME school.[5] This would

[5]See Black (1970); Fama (1980, 1982); Hall (1981, 1982); and Greenfield and Yeager (1983).

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be a rise in share banking (of the mutual fund type). Much attention has been given to the dramatic growth in money market mutual fund shares (see, for example, Edwards 1993 and Hale 1994). David Hale (1994) notes that in the United States, where the trend has been most in evidence, "mutual funds are overtaking banks as the main repositories of household wealth and suppliers of capital to small and medium-sized companies." The U.S. mutual fund industry had an asset total figure of barely 10 percent of bank deposits in the early 1980s but by 1993 that figure had risen to 85 percent. In 1993, 28 percent of U.S. households had membership in a mutual fund, against 6 percent in 1980.

Eugene Fama (1985) and Joseph Stiglitz (1985) argue that what is unique about traditional banks is their access to private information about the creditworthiness of potential borrowers and their ability to act prudently on the basis of that information. This defining characteristic has been seriously questioned by the ability of nonbank investors to avail of the considerable fall in the cost of collecting information about potential borrowers in recent years, which may help to explain the rise of securitization and mutual funds as institutions of alternative intermediation (Cummings 1987). In conjunction with the improved risk-return performance that is associated with share bank savings (e.g., money market mutual funds) relative to par-value bank deposits, the rise of share banking can be more clearly understood.

The appeal of share banking may be further enhanced if Glasner's (1989) contention is correct. He points to two conditions that are necessary for bank runs to arise. They are that depositors be entitled to a fixed nominal claim on demand and that there be a loss of confidence in the solvency of the bank. The value of securitized assets held by mutual funds on behalf of their investors is marked to market continuously. This reduces any inclination to start a run on these banks since to do so would reduce confidence in the value of the bank's assets which would be reflected immediately in their market value. Selgin and White (1994: 1728) state the case clearly and convincingly:

> There is no point running on a mutual fund because there is no greater expected payoff from closing one's account ahead of others. Any fall in the value of a mutual fund's assets is shared immediately by all account holders. A large enough fall in the value of an ordinary bank's assets, by contrast, brings the value of the assets below the (unchanged) value of debt claims, in which case depositors who close their accounts first may get a greater payoff than those who close their accounts last.

Bank runs can therefore be obviated by backing transactions media by equity claims (the money market mutual fund model) rather than

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by debt claims (the traditional banking model). It should, however, be pointed out that Selgin and White (ibid.: 1729) put forward two reasons as to why demandable debt exchange media would survive under laissez-faire banking. The first is that equity claims would have fluctuating value so they would "be inconvenient to use as currency." This is an acceptable argument but would be undermined were transactions to be settled electronically rather than by currency because the fluctuating value of equity claims would not be an inconvenience in making payments electronically where payment involves bookkeeping debit and credit entries rather than physical exchange of media. The second reason they put forward for demandable debt surviving is that "it beneficially constrains banks to act in the interest of shareholders, precisely because claim holders have the option of forcing liquidation."

How the New Payments Technology and Securitization Could Realize the NME Vision

The NME school of laissez-faire banking envisages transactions being effected without the use of tangible money. Trade would be executed by the instantaneous debiting and crediting of liquid wealth accounts (McCallum [1985] terms this an accounting system of exchange). Together, the developments in retail payment instruments and financial innovation discussed above seem capable of bringing about a situation where it will be possible to replace money with productive liquid assets as transactions and settlement media. In this accounting exchange system, transactions are effected by means of signals to an electronic accounting network resulting in appropriate credits and debits to the wealth accounts of buyers and sellers. All wealth accounts in this accounting exchange framework are highly divisible. Ownership of securitized claims is transferred to settle transactions. Settlement is as close to instantaneous as makes no material difference, i.e., all retail payments are settled in real time, in which case there is no need for a wholesale interbank clearing system. Interest is earned on claims up to the moment that each is spent on the purchase of a good or service. The purchaser then forfeits ownership of an amount of assets equal to the nominal value of the purchase. Once ownership is electronically transferred to the vendor, the recipient immediately starts to earn interest on the transferred amount at market rates.

In such an accounting exchange framework there is no need to hold a temporary abode of non-interest bearing purchasing power, i.e., money. This is best understood in the context of the standard Keynesian micro-foundations of the demand for money (Baumol 1952,

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Tobin 1956). Baumol's representative individual determines his optimal demand for money, M, as a function of a number of variables related through the well-known "square root rule," $M/P = (1/2)\sqrt{2bT/R}$. The aspect of this money demand function which is of interest to us is the "brokerage fee," b. This is the fixed cost of exchanging bonds for cash in order to be able to purchase goods and services. With the growing sophistication in the electronic transfer of funds, brokerage fees, widely defined to include the opportunity cost of leisure time forgone, are undoubtedly falling and at a dramatic rate. Should brokerage costs fall to a negligible level then no money will be held. The advances in retail payments efficiency along with the growth in securitization, already mentioned, may effect a transition to such a state of the world where the current ubiquitous monetary exchange system would be replaced by an accounting system of exchange.

The Evolutionary Route to a Separation of the Unit of Account and Media of Exchange

Any transition from the current monetary exchange system to an accounting system of exchange is likely to be a slow piecemeal process. NME theorists argue that a new unit of account based on some quantity of a commodity or bundle of commodities would be required in a cashless economy based on an accounting system of exchange. We believe that if an accounting system of exchange were to emerge slowly over time with electronic exchange of securitized claims coming to replace fiat money as settlement media, the unit of account function of the fiat dollar need not be jeopardized. Fiat money would no longer be a preferred medium of exchange so demand for it in that capacity would no longer exist. Fiat notes and coin, however, have long been a collector's item among numismatists, irrespective of whether the particular notes and coin continue to be used in settling transactions. As fiat notes and coin become increasingly rare among the public, it is, accordingly, likely that because certain fiat note and coin issues remain popular among collectors they will continue to have positive value relative to other goods even as demand for them as media of exchange disappears. So long as fiat notes and coin have a determinate and positive value (be that as a medium of exchange or, as is more likely to be the case in the future, as an asset) relative to other assets, the role of the fiat dollar as a unit of account need not be jeopardized. If there is no demand for money as an asset in the accounting system of exchange, then the adoption of a commodity-based unit of account such as the ANCAP of Robert Hall (1981) would need to be considered.

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The demise of currency as a transactions medium, therefore, need not jeopardize its role as a unit of account so long as there is some alternative demand for it as an asset. It is, accordingly, difficult to agree with the viewpoint of those who would argue that the disappearance of outside money as a circulating transactions medium would render the price level anchorless and subject to "aimless drift" (Gurley and Shaw 1960: 253–56) or have consequences for the macroeconomy more generally that were "drastic" (Wallace 1986: 206).

The modern free-banking school argues that a continued demand for fiat money as a bank reserve medium employed in interbank transactions would sustain the unit of account function of such money. There are sources of reduced demand for central bank money at the wholesale interbank level which are related to improvements in payments technologies and indeed mirror what is happening at the retail level. Real time gross settlement (RTGS) systems have already been introduced in some countries and their introduction in European Union countries is due to be completed in 1996. A priori, a movement from net to gross settlement, would require banks, ceteris paribus, to hold a once-off increase in reserve balances. That would certainly be the case if the type of RTGS chosen were *pure* gross settlement. RTGSs, however, when fully operational, have considerable potential to economize on the use of central bank money by increasing its velocity of circulation.

The experience of the Swiss Interbank Clearing (SIC) system, one of the first RTGS systems, is instructive in this respect. The SIC was introduced in 1987. It directly replaced a net settlement system in January of that year. A change of liquidity regulations in January 1988 in Switzerland made the holding of reserves by banks voluntary. Within three months, SIC participants had reduced their cumulative reserve holdings from 7.5 to 2.6 billion Swiss francs and the turnover ratio of daily payment values to reserves had increased from 12 to 54 on an average day (Folkerts-Landau 1990: 15). Although it could be argued that this sharp decline in reserve holdings was due to private banks adjusting their reserve balances to the level of unconstrained working balances that would have existed if reserve requirements had not been in place to begin with, Vital (1994: 8) reports that the level of reserve balances has continued to fall. By 1994, reserve balances held by SIC participants were of the magnitude of 2 billion Swiss francs while the value of payments per day continued to rise steadily, yielding a daily turnover ratio of 64 in January 1994.

It would seem implausible that, six years after the removal of reserve requirements, banks would still be adjusting their reserves downwards to the level that would have existed in January 1988 if statutory reserve

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requirements had never been in place. If the process of adjustment was still occurring in 1994 then this suggests that SIC member banks have been very slow to adapt reserve holdings to their optimum level. An alternative explanation of the secular decline in Swiss banks' reserve holdings is that those banks quickly adjusted their reserves holdings to an optimum level following the January 1988 deregulation, but that the optimum level of reserves has been falling in the intervening years due to the greater efficiency in the use of central bank money arising from the employment of RTGS. This latter explanation seems the more plausible to us. The Swiss chose to adopt a RTGS that operated on a queued basis, i.e., where payments are processed on a first-in first-out basis. This feature allowed banks to have lower holdings of reserves than they would need under pure RTGS. Furthermore, efficiency improvements continue to be achieved under RTGS that allow a lower amount of reserves to be held in order to make the same, or indeed a greater (as has transpired in the SIC), value of interbank payments in a day. The SIC, for instance, has recently encouraged less urgent payments to be settled at the less busy earlier part of the day by charging lower transaction fees at that time than later in the day. The consequence has been a greater smoothing in the flow of payments being made and, with less payments being made at the end of the day, a lower amount of reserves being required to settle total daily payment flows.

The actual experience of this comparatively new and increasingly popular wholesale payments technology, RTGS, therefore, points to the possibility that the demand for fiat money as reserves could decline as a proportion of interbank transactions. Indeed, the more likely scenario, as the Swiss experience shows, is that the absolute nominal value of reserves may fall even in the situation where the value of wholesale transactions continues to grow in the long run. Furthermore, if one considers that it may, in time, be feasible for debtor banks to start transferring liquid "productive" assets (which, unlike reserves, earn market rates of interest for their holder) to creditor banks to settle interbank debts, then the need to mediate interbank transactions with central bank money may be obviated. On the basis of bilateral agreements between banks, electronic messaging could be used to transfer the ownership of an amount of a mutually agreed marked-to-market asset equivalent to the interbank obligation without any need necessarily arising to redeem the underlying asset itself. We therefore do not see interbank demand as necessarily providing a long-term source of demand for central bank money.

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Monetary Equilibrium and Disequilibrium

Many economists trace the main causes of historical business cycles to money market disequilibria. An increase in the demand for money to hold, or hoarding, exacerbates the coordination problems in economies with decentralized decisionmaking. This is because money withheld as an abode of purchasing power constitutes potential purchasing power in general. A substitution away from expenditure or savings (which are actual demands for specific goods and assets, respectively) in favor of money to hoard diminishes the number of useful signals sent out by households to firms as to what to produce now and how much to invest for future production. The result is a coordination failure, a failure of production and expenditure plans to mesh in the aggregate leading to a downturn in economic activity.

In an accounting system of exchange of the type outlined above, with a viable unit of account, real time gross settlement and liquid securitized wealth, those types of coordination problems are much less likely to arise. This is because all wealth, being liquid and perfectly divisible, would be capable of acting as transactions media. Furthermore, the total volume of those transactions media would be in infinitely elastic supply relative to the volume required for actual trades in any small finite period. In such a situation, the coordination difficulties that may arise in monetary economies could not arise because there would be no need to withdraw income from the income-expenditure stream in order to accumulate balances of general purchasing power. If the monetary disequilibrium account is correct, then cyclical fluctuations in output and employment arising from monetary disequilibria would disappear in a pure accounting system of exchange.

Indeed it may not be too panglossian to predict that an economy based on a pure accounting system of exchange would be more stable and less inflation prone than one based on a monetary system of exchange. And, if the types of asset price bubbles seen in the 1980s are driven predominantly by excess money growth as monetarists would argue, then, by corollary, large asset price collapses would not occur in a pure accounting system of exchange. If large swings in asset values were thereby obviated, the stability of a banking system of the mutual-fund type, which we envisage being the basis of free banking in the future, would be further underpinned.

Skepticism on White's Objections to the Viability of Cashless Payment Systems

Lawrence H. White (1984b) has questioned the likelihood of the spontaneous emergence of a competitive cashless payments system

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from the current ubiquitous monetary system of exchange. He identifies three conditions that would be necessary for this transition to occur: (1) the disappearance of redeemable inside money; (2) the disappearance of outside money; and (3) the redefinition of the unit of account in terms of a numeraire other than outside money.

White argues that the first of these conditions is unlikely to happen since par value deposits, being claims on debt, are superior as media of exchange to mutual fund shares, which are equity-type claims. Unlike the latter, contractual guarantees of the purchasing power of deposits can be given in advance. Another reason offered by White as to why (demand) deposits are likely to survive, even under unregulated competition, is that the payments system they provide is less costly. The second condition will not hold either, he argues, so long as manual transfer of currency remains the least costly method for executing certain transactions. On the third point, White cannot see the unit of account being divorced from the medium of exchange.

White (ibid.: 707) is correct in asserting that the "historical fact is that deposit banking did not naturally grow up on an equity basis." The cost of gathering information central to valuing bank assets on an ongoing basis would have been excessively high in the past. Accordingly, equity-type banking was not a realistic option. Now, however, developments in information technology are making the operation of continuous marking to market of even small savings claims efficient. Consequently, a "natural" blockage to share banking is being increasingly eroded. This fact is supported by the greater mediation of savings into equity-type claims: for instance, as already cited, in the U.S. mutual funds are now equal to about 85 percent of U.S. bank deposits against barely 10 percent in the early 1980s.

Although the capital value of the typical investor's share in a mutual fund is variable, this scarcely presents a problem. The asset diversification which mutual funds are capable of achieving is much greater than that achievable by traditional banking. This feature enables idiosyncratic risk to be diversified away. As a result, the maximum variability in an individual's shareholding, which itself replicates the composition of the fund's overall portfolio, is reduced to a low level. Furthermore, all wealth in the economy can, in theory, be securitized to form liquid wealth accounts. The flow demand for those wealth accounts to perform the role of transactions media for the flow supply of goods and services in any small interval of time (a day, say) would be extremely low relative to their stock supply. Therefore, there would scarcely ever be any question of an individual finding that his liquid wealth account would be inadequate to cover daily expenditures despite its being continually marked to market.

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White (ibid.: 710) believes that exchange in a cashless world would burden wealthholders with "relatively high transactions costs in unloading payments property." Using any asset other than money (fiat or commodity money) burdens someone with paying the significant bid-ask spread involved in exchanging that asset, a cost that does not arise in exchanges undertaken in money. We have argued earlier that the cost of using an electronic exchange network based on optic fibers and smart cards may soon be far lower than that pertaining to current monetary exchange systems. That saving could include bid-ask spreads on assets being reduced to negligible levels. If so, White's argument would be undermined. Already effectively redundant for large-value transactions, currency would no longer even remain the least costly method for settling small-value transactions.

As argued previously, the demise of outside currency as a transactions medium need not jeopardize the continued role of the fiat dollar as a unit of account. Even as of now, given that currency constitutes only 1 percent of transactions media in the United States and this is predominantly held by households, there must be vast areas of business activity which operate smoothly without ever coming into contact with the medium of exchange which incorporates the unit of account (i.e., currency). For those transactions there is effective separation of their medium of exchange (exclusively inside money) from the unit of account. As retail electronic payments vehicles are diffused throughout the economy and as payments habits evolve, those activities where there is effective separation of the medium of exchange and the unit of account will grow still further and will probably ultimately dominate.

Conclusion

If the emerging electronic payments media of prepaid, debit and smart cards were to be issued exclusively by purely private market concerns and if they were to succeed in replacing currency, then inside money would completely replace outside money and laissez-faire banking could emerge spontaneously from the technology. Those electronic means of payment combined with the ongoing process of financial innovation, which is making wealth increasingly liquid, could eventually result in an efficient and stable laissez-faire banking system.

It is possible to visualize an endpoint to the process of payment, financial, and institutional innovation in which neither outside nor redeemable inside money is any longer held for settling transactions and all payments are carried out via transfer of productive liquid assets; trades are executed by instantaneously crediting and debiting wealth accounts; buyers' creditworthiness is verified by instantaneous

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electronic access to their wealth accounts and transactions are settled with finality and virtually instantaneously at the moment of trade. The disappearance of fiat money as a transactions medium would be unlikely to impede its role as a unit of account because there would still be a demand for fiat notes and coin as assets. Finally, the accounting system of exchange would be superior to a monetary exchange system in coordinating economic activity.

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A Modest Proposal to Deregulate Infant Adoptions

Donald J. Boudreaux

In his famous satire, Jonathan Swift "modestly" proposed slaughtering babies and feeding them to hungry Irish folk. Thanks to Swift's masterful lampoon, any proposal for modestly changing public policy affecting children risks being branded a satire. So I proclaim up front my sincerity in proposing that pregnant women, and women who have just given birth, be allowed to contract freely with adoptive parents at mutually agreeable prices for the sale of parental rights in their infants.

The proposal is not original. Richard Posner has long championed the cause of a liberalized adoption market.[1] But most replies to his proposal have been critical, too often failing to rise above invective.[2] Such negative reaction belies both the modesty and the worthiness of Posner's proposal. The proposal is modest because it merely extends to birth mothers a liberty now enjoyed by many adoption agencies: the liberty to sell parental rights to adoptive parents at mutually agreeable prices. The proposal is worthwhile because it promises gains to all relevant parties to adoptions—birth mothers, couples wishing to adopt infants, and children.

Opposition to birth mothers' voluntary sales of parental rights is founded on faulty reasoning. I use basic economics to highlight the benefits of liberalized adoption and to address some of the most common objections raised by those who insist that children or society would be harmed by the free exchange of parental rights in infants.

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[1]See Landes and Posner (1978) and Posner (1987).

[2]See, e.g., Cohen (1987).

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Some preliminaries are in order. First, I refer throughout to the "sale of parental rights" rather than to "baby selling." When a birth mother gives a child up for adoption, she legally transfers her parental rights to the adoptive parents; the adoptive parents gain all those rights, but only those rights, that the birth mother possessed before the adoption. Such rights are those that all non-derelict parents have in their children. The rights do not include license to abuse the child or to use him or her as a slave. Parents who purchase their parental rights from birth mothers would have precisely the same rights, and *only* those rights, that they would have if their children were their biological offspring (Landes and Posner 1978: 344). Branding the sale of parental rights "baby selling" (Baker 1978; Fox 1993) provokes people reflexively but wrongly to assume that some horror akin to slavery is being advocated.

Second, I deal here only with the sale of parental rights in infants (say, children nine months old or younger). The proposal may or may not be suitable for older children; I leave investigation of that issue for another time.

Third, I assume that only adult birth mothers have initial parental rights in children. The case I have in mind is the all-too-common one in which an unmarried woman has, or is having, an unwanted child and the father either is unknown or has ignored his parental responsibilities. Cases in which the birth mother is married or the father knows and cares about his child, or in which the birth mother herself is still a child, are more complex. Perhaps the law should give those fathers, or the parents of minor birth mothers, some say in adoption decisions. I do not, however, explore in this paper the desirable specifics of those fatherhood rights or of the rights of parents of minor birth mothers.

Fourth, I assume that the law prohibits resales of parental rights by adoptive parents. Once a final decree of adoption is issued for a particular child, that child's adoptive parents may not resell their parental rights in this child.

The Baby Shortage

All agree that adoptable healthy white infants are in short supply today. The National Committee for Adoption (1989) estimates that in the United States 20 couples are willing to adopt for every available infant. Various reasons are offered for the shortage. Low-cost methods of birth control and legalized abortion arguably reduce the absolute

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number of children born to women who do not wish to raise them.[3] The availability of increased welfare payments makes unwed mothers more likely to keep their children. In addition, the fact that women increasingly pursue professional careers before starting a family raises the demand for adoptable infants. A woman's ability to conceive and successfully carry a child to term decreases as she ages. Consequently, as more women delay having children, the number of couples suffering infertility problems rises, causing more to seek adoption.

Although medical, legal, and demographic changes affect both the supply of, and demand for, parental rights, such changes alone are insufficient to cause a baby shortage. Supplies and demands for all sorts of goods change frequently without creating lasting shortages. For a shortage to persist, prices paid to suppliers must somehow be held below market-clearing levels. And so it is with the current baby shortage. No market-clearing price for parental rights emerges because birth mothers cannot contract freely with adoptive parents.

Adoption in the United States is governed principally by state laws. Currently, birth mothers in all states and the District of Columbia are barred from selling their parental rights (Medoff 1993: 60). Birth mothers can give the rights away, but they cannot receive monetary payments in return. Monetary compensation is allowed only for out-of-pocket medical expenses for the prenatal care and birth of children. (In some cases, these expenses include psychological counseling for birth mothers). But the amounts are limited to ensure that birth mothers do not profit by offering their children for adoption.

State regulations also obstruct efforts by birth mothers and prospective adoptive parents to learn about, and to contact, each other. The most restrictive states simply ban "independent" adoptions: adoptions in which adoption agencies are not intermediaries. Other restrictions include criminal prohibitions against advertising by prospective adoptive parents, prohibitions on out-of-state couples applying for adoption within a state, and requirements that independent (though not agency)

[3]Pierce and Vitillo (1991) list the commonly cited demographic and legal facts that allegedly cause the baby shortage, without ever mentioning that the price of parental rights is capped at an artificially low level by prohibitions on birth-mother contracting. It is interesting to note that the absolute number of adoptions began to fall in the United States two years *before* the Supreme Court declared unconstitutional all legislative restrictions on first-trimester abortions in *Roe v. Wade* (1973). See Pierce and Vitillo (1991: 133). Also note that greater availability of birth control and abortion will not necessarily decrease the absolute number of unwanted pregnancies. Posner explains (1992: 415) that, although easy access to birth control and abortion will reduce the frequency of unwanted pregnancies relative to the frequency of sexual intercourse, the amount of sexual intercourse might increase to such a large extent (in response to the lower risk of pregnancy) that the absolute number of unwanted pregnancies actually rises.

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adoptions be "open"—that is, that adoptive parents give their full names and addresses to birth mothers.[4]

Proponents of such restrictions argue that the baby shortage can be reduced by increased adoption awareness and, perhaps, by government subsidies for adoption. But even if such policies fail to alleviate the shortage, these proponents insist that birth mothers never be allowed to sell parental rights for a profit.

Let Birth Mothers Keep the Profits from the Transfer of Parental Rights

Birth mothers should be allowed to contract freely with adoptive parents for the sale of parental rights in infants at whatever prices they find mutually agreeable. Allowing such contracting does not necessitate abandonment of other regulations on adoption. Courts will still have to sign off on each adoption, allowing judges to ensure the suitability of adoptive parents. Indeed, all prospective adoptive parents could be required (as they are now) to pass home studies before being eligible to contract with birth mothers. Finally, all contracts between birth mothers and adoptive parents will be subject to the same checks on fraud, duress, and other abuses that traditionally limit contractual commitments.

The most obvious consequence of greater freedom of contract for birth mothers is that the baby shortage will end. The supply of adoptable infants will increase as birth mothers seek to sell their parental rights for a profit. The price birth mothers receive for parental rights will rise until the supply of those rights expands sufficiently to meet demand. Importantly, greater numbers of adoptable infants means that fewer couples must remain childless. That benefit is immense for those suffering the agony of unwanted childlessness.

A second effect will be greater wealth for birth mothers.

Third, there will be fewer abortions. Allowing women to sell parental rights in their infants at market prices transforms previously unwanted fetuses into valuable capital assets. If parental rights in infants can be sold profitably by birth mothers, women will be far more reluctant to abort their fetuses. Just as a car owner sells rather than destroys an automobile when he decides that he no longer wants the car, a pregnant woman with transferable parental rights is much more likely to carry her pregnancy to term and then offer the baby for adoption

[4]Roughly 70 percent of all U.S. adoptions are administered by licensed adoption agencies. The remaining 30 percent of adoptions are independent. (See National Committee for Adoption 1989.)

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rather than abort the fetus. Allowing women with unwanted pregnancies to sell their parental rights for a profit will increase the cost of abortion to those women and, hence, reduce its incidence.[5]

Fourth, the average health of infants will improve. Because parental rights in healthy infants will command higher prices than will parental rights in unhealthy ones, pregnant women will have stronger incentives to seek prenatal care of their fetuses and to avoid harmful habits such as alcohol and drug abuse.

Fifth, the incidence of child abuse will decline. Because the current welfare system rewards women for keeping their children (Medoff 1993: 66), many children who are only marginally wanted by their birth mothers are kept by the women. Such children are surely more subject to neglect and abuse than they would be if they were adopted by loving parents. Ability to receive payment for parental rights will cause many such children to be put up for adoption.

Sixth, and relatedly, fewer children will be placed in foster care, itself a dysfunctional institution (Pelton 1991). Birth mothers who now choose not to keep their children are more likely to place those children in foster care rather than make them available for adoption (Landes and Posner 1978: 338). According to Conna Craig, president of the Institute for Children, 4 percent of the 35,000 children now in foster care who are eligible for adoption are infants.[6] Birth-mother ability to keep the profits from the transfer of parental rights raises the likelihood that birth mothers will both learn about, and take advantage of, the adoption option.

Seventh, the price of infertility treatments might fall. Infertility treatments and adoption are substitute methods of securing parental rights. Thus, an increase in the supply of adoptable infants will reduce the demand for infertility treatments. The price of infertility treatments will likely fall as a consequence.[7]

Current adoption law thus creates avoidable heartache and expense for all parties interested in infant adoptions. Liberalizing birth-mother contracting will improve adoptive-parents' chances of adopting the

[5]In his useful study of the economic determinants of adoption under current law, Medoff (1993: 66) finds that Aid to Families with Dependent Children payments make "poor women regard adoption as a less desirable alternative than keeping the child or having an abortion." Medoff's data also show that single women, as well as working women, with unwanted pregnancies are "more likely to choose an abortion relative to adoption." That pattern will likely change with a freer adoption market.

[6]Information from personal correspondence.

[7]If substantial economies of scale characterize the operation of infertility clinics and infertility research, it is possible that a reduction in the demand for infertility treatments will result in higher, rather than lower, prices of such treatments. Thus the use in the text of the qualifier "likely."

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child (or children) of their dreams, while allowing birth mothers to acquire greater wealth. The policy change might also allow couples suffering infertility problems to pay lower costs for infertility treatments. Most important, many children who would otherwise not be born, or who would be born with birth defects, will be blessed with healthy lives. No party to the adoption process loses—save for abortion clinics as well as adoption agencies and state bureaucracies that will lose some of their business to private arrangements.[8]

If all parties to the voluntary agreements benefit, those who morally object to such agreements are obliged to explain why their objections should trump a proposal yielding widespread benefits with little or no evident costs. Michael Trebilcock (1993: 29), in his discussion of legal restrictions on market transactions, correctly insists that when "we are contemplating prohibitions or constraints on exchange relationships that parties thereto would in the absence of such prohibitions or constraints, apparently wish to enter into, ultimately some justification is required for this form of paternalism."

Justifications are offered, but none is persuasive. Here are the most commonly encountered reasons for denying freedom of contract to birth mothers.

"Economic Motives Are Inappropriate for Familial Matters such as Adoption"

Among the most oft-repeated objection to greater contractual freedom for birth mothers is the claim that human life is not an appropriate object of economic calculation; economic motives should not intrude into such personal decisions as whether or not to adopt a child or to give a child up for adoption. According to Martha Field (1990: 30), "There are some types of things that our society does not want measured in terms of money. Society may want to do what it can to help people keep these in a personal sphere that is distinct from the commercial."[9]

This claim is laden with both emotion and vagueness. Depending on what is meant by terms such as "commercial" and expressions such as "economic motives" or "measurement in terms of money," such claims are either trivially true or factually incorrect. On one

[8]Adoption agencies oppose not only freedom of contract for birth mothers, but even independent adoption (Pierce and Vitillo 1991: 141). Of course, birth mothers who choose the independent route are currently not permitted to sell their parental rights at market-clearing prices.

[9]Perhaps the most strident opponent of the "objectification" that allegedly attends commercial transactions is Margaret Jane Radin. See Radin (1987, 1991).

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hand, if what the speaker or listener has in mind is that slavery should not be reinstated (slaves, after all, were humans whose lives were measured "in terms of money"), then no sane person disagrees. As explained above, allowing birth mothers to sell their parental rights voluntarily to adoptive parents in no way connotes a return to slavery. On the other hand, if the speaker or listener really believes that economic considerations should play no role in familial matters, then he or she has not thought through the full implications of this belief. In fact, family matters, including child-rearing and adoption, are routinely objects of economic calculation.[10] Economic considerations are inescapable in the teeth of scarcity (although many people remain incognizant of the pervasiveness of such influences).

For example, many people—and responsible persons especially—make explicit economic decisions about whether or not to have children and, if so, when. Children are costly in monetary as well as nonmonetary ways. Raising them requires sacrifice. The things sacrificed—be they European vacations, nicer automobiles, additional education, more quiet time, or whatever—are what parents pay for children. These costs are not always out-of-pocket cash expenses, but form should not blind us to substance: they are genuine economic costs, and they are regularly considered when people make family decisions. Young newlyweds with no savings might delay starting a family to establish firmer financial grounds for raising children. Other couples might choose (say, for career reasons) never to have children. The costs and benefits of having children are inevitably weighed against each other, and decisions made accordingly. Surely such decisions are not immoral, unethical, or impersonal because they are made with economic concerns in mind. Indeed, we properly denounce people who have children *without* adequately considering the economic consequences of doing so.

In addition to the economic considerations mentioned above, medical treatments for fertility problems are undertaken in light of financial constraints. Those treatments are expensive, costing patients hundreds—and often several thousands—of dollars monthly. Decisions on whether or not to pursue such treatments and, if so, choosing which particular treatments to pursue and for how long, are inevitably made in the face of resource constraints. Similarly, birth mothers who

[10]The classic text on the economics of the family is Becker (1991). Indeed, even the behavior of young children can usefully be analyzed with the rational-action assumptions of modern economics. See Anderson and Tollison (1991). Margaret Brinig (1994a, 1994b), and in Brinig and Alexeev (1995), creatively uses economics to explore family questions, although she admits that economics presents "only a partial picture" (1994a: 1573).

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put their children up for adoption under current law usually do so for economic reasons: they cannot afford to raise their children.

Those who argue that economic considerations ought not influence decisions regarding children and child bearing must, for consistency's sake, argue that unwanted babies should not be given away, and that couples and single women should not hesitate because of "mere" financial reasons to have children. Consistency also demands that opponents of a deregulated market in parental rights support bans on money payments for infertility treatments. Yet there is no widespread opposition to unregulated prices for fertility treatments, or to people making decisions to bear or to keep children in light of explicit economic concerns. These facts dispel claims that society generally disapproves of rational economic calculations in the realm of child bearing and child rearing.

"Babies Should Not Be Traded Commercially"

Some opposition to a freer market in parental rights stems not so much from the belief that it is unethical to ground family decisions on cost-benefit analysis as from the conviction that babies ought not be objects of commercial exchange.[11]

This argument also proves too much; it suggests that doctors, nurses, and clinics specializing in medical treatment for people suffering fertility problems should not be allowed to sell their services for a profit. On the supply side, medical infertility specialists employ their knowledge to improve infertile couples' chances of conceiving and successfully carrying children to term. These physicians and technicians profit by selling their child-creation services. On the demand side, infertility patients spend money to purchase parental rights in infants. A couple spending $5,000 monthly for artificial insemination, *in vitro* fertilization, or other treatments for infertility, uses money to pursue a child no less so than does a couple who spends money to purchase parental rights in adoptive infants.

It may be countered that physicians working to improve couples' chances of having babies do not really sell parental rights in children: physicians sell skilled *services* that improve couples' chances of having their own biological children. Might we not, though, recast what birth

[11]"Judge Posner's model also makes babies fungible, smoothing over the intangible qualities that make each child unique. If a baby's value can be expressed in dollars, then a baby can be compared to a car, a dress, a year's tuition, or a trip to Bermuda. There are already too many parents to whom a child's use value is less than satisfying without encouraging such dissatisfaction by supplying a competing exchange value" (Frankel and Miller 1987: 102). See also Radin (1987: 1850).

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mothers sell as their child-creation services? Even though the law gives birth mothers initial ownership of parental rights in whatever children they birth, why deny women the liberty to profit from their abilities to produce babies that other couples earnestly want and are willing to pay for? And why deny infertile couples the right to contract voluntarily with birth mothers? Adoption may well be less costly than infertility treatments for many couples. Not only will prices charged by birth mothers likely be lower than the costs of adopting through adoption agencies (see below), but adoption avoids the risks of medical complications that attend the use of drugs and intrusive surgery often entailed by infertility treatments. These risks include harm to infertility patients as well as to the children born as a result of these treatments (Prichard 1984: 343).

More significant, however, is the law's failure to truly prohibit commerce in parental rights. The law prevents only unlicensed, private individuals—most notably, birth mothers—from profiting from such commerce. Adoption agencies today (some of whom are for-profit firms) legally sell parental rights in infants at profitable prices. Not all states regulate the prices that adoption agencies charge for their services.[12] Fees charged by for-profit agencies run as high as $30,000 per adoption, while fees charged by nonprofit agencies reach $25,000 (Sullivan and Schultz 1990: 39–41). And often, agency fees depend on adoptive parents' income: lower-income adoptive parents pay less than higher-income parents (Gilman 1992: 33). In economic terms, adoption agencies price discriminate, a practice that increases their revenues.

Of course, agencies do not list "infant" or "parental rights" on itemized bills. But, again, form should not camouflage substance: adoption agencies sell parental rights at prices kept artificially high by laws prohibiting birth mothers from contracting directly with adoptive parents. Figure 1 depicts the economic consequences of denying freedom of contract to birth mothers.

S represents the supply of parental rights in infants. Quantity supplied increases as the price received by birth mothers rises.[13] D represents the demand for parental rights to adoptive children. As the price of parental rights rises, fewer are demanded. With no restrictions on the abilities of birth mothers to contract with adoptive parents, the equilibrium quantity of children adopted per period of time would

[12]"While some states set ceilings on the fees that agencies can charge, others do not" (Gilman 1992: 33–34).

[13]Because some women will wish to put their babies up for adoption even at a zero price, the supply curve intersects the quantity axis at a positive quantity (Q_N).

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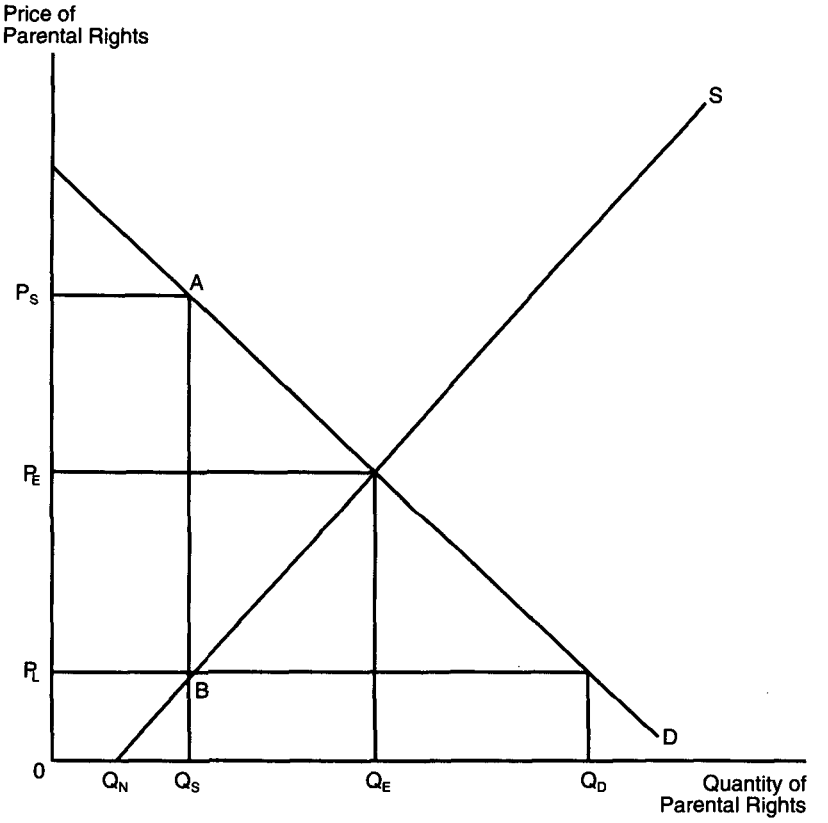
FIGURE 1

THE MARKET FOR PARENTAL RIGHTS



be Q_E; the equilibrium price would be P_E. Babies would not be in short supply.

But existing prohibitions on free contracting keep artificially low the prices that birth mothers may legally receive for their parental rights. In Figure 1, birth mothers can legally receive no price higher than P_L. The law allows small payments to birth mothers as compensation for out-of-pocket medical expenses connected with prenatal care and birthing. But P_L is substantially below P_E; thus, a "baby shortage" (Q_D—Q_S) is created by restricting the prices that birth mothers receive for their parental rights.

Importantly, though, the full price paid by adoptive parents for parental rights is *not* limited to P_L. When quantity supplied is limited to Q_S, the marginal value of parental rights in adoptive children is P_S. That is, laws that have the effect of limiting the supply of parental

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rights in adoptive children to less than Q_E ensure that each "unit" of those rights is valued by adoptive parents at some price higher not only than the parents are allowed to pay to birth mothers, but higher also than P_E. Artificial excess value ("rent") is created, and birth mothers cannot legally receive that excess value. But legal prohibitions on birth mothers' abilities to collect those rents do not make the rents disappear. Because adoptive parents will pay up to P_S for each of the available Q_S 'units' of parental rights, competition among adoptive parents raises the full prices paid for parental rights. The amounts that adoptive parents pay to adoption agencies as fees and expenses are bid up to reflect the artificial scarcity of parental rights. Adoption agencies rather than birth mothers reap the financial fruits of competition among prospective adoptive parents for the parental rights that are in short supply. Agencies' practice of labeling their charges "service fees" or "home study fees" does not alter the fact that the fees are determined by the forces of demand and supply, and that they reflect the artificially created scarcity of parental rights in adoptable infants.

To be sure, the average pecuniary price paid by adoptive parents to adoption agencies is not bid all the way up to P_S. If it were, there would be no queues—i.e., long waiting lists—of would-be parents wishing to adopt healthy white infants (Landes and Posner 1978: 326). Why adoption agencies do not raise their average fee to P_S is not clear. One reason may be that, if adoptive couples paid in dollars an average of P_S to agencies, too many birth mothers would be attracted into the black market. As birth mothers shift away from agencies and to the black market, agencies' supply of adoptable infants falls. Thus, given the high costs of eliminating black markets, adoption-agency profits are maximized at some price less than P_S.

Queuing, of course, is a real cost borne by prospective adoptive parents. The monetary value of the time spent waiting as well as the anxiety caused by queuing, combined with the pecuniary fees charged by agencies, will be equal at the margin to P_S (Barzel 1989: 16–19). But because adoption agencies do not receive the full P_S per child, birth mothers are not as tempted to sell their parental rights in a black market as they would be if they witnessed adoption agencies taking on average P_S per child.

The problem with this explanation is that it leaves unexplained why the queuing itself is not more fully exploited by black-market entrepreneurs. Entrepreneurs willing to risk criminal and civil penalties should be able to transform some of the queuing costs into monetary payments by adoptive parents.[14]

[14]A defender of the explanation might respond, following Hayek's discussion of prices as guides to market opportunities (1945), that queuing sends out only terribly distorted and

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An alternative explanation for why adoption agencies fail to convert the entire area P_SABP_L into pecuniary payments by adoptive parents is suggested by Sam Peltzman's (1976) theory of regulation. Peltzman pointed out that interest groups often compete in the legislative arena against opposing interest groups, as well as against the public interest. If Peltzman is correct, adoption agencies may fear that charging pecuniary fees equal to P_S would result in regulation more adverse to agencies' interests.

Nevertheless, regardless of the form in which adoptive parents pay P_S, those who succeed in securing a child pay more than P_E, which is the amount they would pay if birth mothers could sell parental rights outright. If the ban on birth-mother contracting were lifted, the full cost to adoptive parents of adopting a child would fall although payments received by birth mothers would rise.[15]

"Only the Rich Will Benefit, while the Poor Will Be Exploited"

While studying law at the University of Virginia, I regularly proposed a free market in parental rights to fellow law students. A large majority objected by asserting that only the rich will benefit.

A valid response to this objection is "So what?" Suppose that it were in fact true that only the rich will benefit if birth mothers are allowed to sell their parental rights. This fact would not justify current restrictions on the abilities of birth mothers to contract. As long as no one is harmed by such sales, it is malice borne of envy (or, in the case of many of my fellow students, of misdirected guilt) to deny the rich opportunities to use their assets in ways that result in loving

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weak signals to potential black-market rivals of adoption agencies. Thus, because much of the price paid by adoptive parents in a queue is hidden from potential black-market rivals, the rivals do not exert much effort to lure birth mothers away from legal adoption agencies.

[15]The nonprofit status of most adoption agencies does not mean that the managers and staff of the agencies do not benefit from charging higher prices. In the United States, a nonprofit firm is a firm not liable for taxes on income derived from the stated charitable purposes of the firm. Such firms have no owners in the conventional sense. That is, they have no residual claimants who can transfer to themselves, in the form of cash, any excess of revenues over costs. Nevertheless, the staff of nonprofit organizations gain to the extent that their agencies' revenues exceed costs. Wages and salaries, expense accounts, and working conditions and other perquisites all improve with higher revenues. A substantial body of work by economists shows that the motive to maximize personal gain is very much alive among people working in the nonprofit sector (Weisbrod 1988).

Regarding adoption agencies whose fees are regulated, such regulation often is based on agency average costs (Carlson 1994: 274), thus allowing agency managers to disguise monopoly rents as costs. In addition, a recent writer noted "states' relative indifference toward agency salaries" (Carlson 1994: 274).

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families for children. The fact that only the rich purchase Mercedes-Benz automobiles, cases of Chateau Haut Brion, and summer homes on Newport Beach is no reason to outlaw the sale of such items. (Incidentally, only the relatively wealthy can now afford infertility treatments. Should such treatments be outlawed because poor people cannot take advantage of them?)

But it is not true that only the rich will benefit. In every voluntary exchange, *both* parties are made better off. Moreover, the nonwealthy will be *better* able to adopt children when birth mothers are allowed to freely sell parental rights. First, adoption agencies under the current legal regime favor well-to-do adoptive parents: the poor tend to be discriminated against even if they are willing to spend as much as their wealthier rivals to acquire parental rights.[16] Second, because political connections and ability to grease palms thins regulatory thickets, poor people are disadvantaged by the current system. Third, as explained above, the full price of adopting a healthy infant is today actually quite high. Not only is the wait long and agonizing, but adoption-agency fees and other out-of-pocket expenses are higher than necessary because the market is controlled. As argued earlier, allowing birth mothers to sell directly to adoptive parents will increase the quantity of adoptable infants supplied for adoption while reducing the role of adoption agencies as middlemen. Market prices paid by adoptive parents for parental rights will fall as a consequence, even as prices received by birth mothers rise. As the price of acquiring parental rights in infants falls, people of modest means are better able to adopt.

Nor will poor women be exploited by being forced into "a new oppressed and undignified occupation" (Shalev 1989: 159). No woman will be coerced into supplying parental rights. And birth mothers—most of whom, presumably, will be nonwealthy—can profit from their sales of parental rights. Given this ability to profit and the voluntary nature of the transactions, to say that greater contractual freedom for birth mothers would lead to the exploitation or "demeaning" of birth mothers is curious.[17] In a freer market, birth mothers would continue to enjoy all the options they have now, *plus* the additional option of selling their parental rights.

[16]The "best interest of the child" standard that is central to modern U.S. adoption law allows agencies, when deciding which would-be parents will be granted rights to adopt children, to weigh heavily and positively the wealth of prospective adoptive parents.

[17]Pierce and Vitillo (1991: 142) are representative of a large class of commentators who assert that allowing women to choose voluntarily to sell their parental rights "demeans biological mothers."

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Opponents of liberalized adoptions might respond that it is unseemly for the poor to be the sole supplier of adoptable infants to the nonpoor. Even granting that the suppliers of parental rights will overwhelmingly be low-income women, this is no argument to prohibit these women from contracting voluntarily with adoptive parents. Prohibiting poor women from bargaining with wealthier adoptive parents for prices that those women find profitable is a peculiar way to safeguard them from exploitation—and a selfish and harmful way to shield the sensibilities of the ethically hyperenlightened from "unseemly," if beneficial, market transactions.

Another argument supporting the exploitation claim is that poor women are generally unable to make sound decisions regarding the disposition of their parental rights. Their immediate need for money causes them to pursue short-term pecuniary gain at the expense of long-term woe. In the words of one commentator, "financial benefits urged upon an often indigent natural mother by a baby-broker become a source of coercion to her to force her to give up her baby" (Katz 1986: 13). Quite simply, a poor birth mother who sells her parental rights today might regret that decision a month or a year or 10 years from now.

Of course, a woman might err in her assessment of the costs and benefits of selling her parental rights, and may later regret her decision. But so, too, might a woman who under current law chooses to give her parental rights away free of charge, as might a woman who chooses abortion or who chooses never to become pregnant. Indeed, any party to any contract may later regret his or her contractual commitment. Such is the nature of uncoerced choice.

Women who, under existing law, give their children up for adoption typically do so because of their immediate financial predicaments; their need for current liquidity makes it prudent for them not to undertake—or to delay undertaking—the role of mother. It is true that the additional financial incentives under a freer adoption market to give children up for adoption will cause some women who would otherwise choose to keep their children, or to abort, to decide instead to sell their parental rights. But allowing birth mothers to bargain for profitable prices with adoptive parents does not create financial incentives for adoption where none existed before. Such incentives exist under current law.

A more fundamental question, however, is why society puts so little trust in birth mothers to make rational decisions regarding adoption of their children under a regime of voluntary contract. That paternalistic lack of trust is bizarre given that the same women are trusted to make abortion decisions, adoption decisions involving no cash pay-

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ments, and decisions to keep and to rear children. If government does not assume the right to second-guess those decisions, the burden of proof is on those who advocate a policy of second-guessing women's decisions to sell their parental rights.

"Free-Market Adoption Will Spawn a Baby Industry"

Another argument against greater freedom of birth mothers to contract with adoptive parents is that the lure of profits will induce women to become pregnant for the sole purpose of selling their parental rights to adoptive couples. While many women will still become pregnant accidentally, others will do so intentionally in search of profits. Such actions create life for all the wrong motives.

Intentional births by profit-seeking birth mothers are a possibility, but it is difficult to see why this outcome is undesirable. The market price of parental rights will reflect adoptive parents' demand for such rights. Willingness to supply parental rights (and hence willingness to become pregnant solely to sell parental rights) will vary with the market price. If demand for parental rights falls, so too will the price of these rights, leading fewer women to offer their parental rights for sale. Likewise, an increased supply of babies lowers the price of parental rights, thereby increasing the willingness of people to adopt. At market-clearing prices for parental rights, birth mothers' supply of these rights will equal adoptive parents' demand for these rights. Any excess supplies of, or demands for, parental rights will be corrected by decreases or increases in market prices. Only women who find market prices attractive will become pregnant for the purpose of profiting from the sale of their parental rights. There is no reason to suppose that the pricing mechanism will fail to keep markets cleared.

To be sure, the market will not work flawlessly, instantaneously matching demand with supply. What happens when a woman becomes pregnant believing that she can sell her baby profitably only to discover, nine months later, that the market price for parental rights has fallen? If the woman has no interest in raising the child herself, she will sell her parental rights at the lower price. Her profits will be lower than she expected when she became pregnant, but that is a risk she assumed when she chose to become pregnant. Women contemplating becoming pregnant to profit from selling their parental rights will account for the risk that the market price nine months hence might fall.[18]

[18]Surrogate-mother contracts can shift the risk of price declines from birth mothers to adoptive parents. By contracting before conception at a known price, a surrogate mother no longer risks having to sell her parental rights at a price she regards as too low.

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In contrast, women who decide that the current market price is too low will not sell their rights. These women keep their children. Of course, women who decide only after becoming pregnant to keep their children retain all parental rights and responsibilities, just as do today's mothers who choose to keep unplanned children. There is no reason to believe that one kind of unplanned child will be treated less well than the other.

"Liberalized Birth-Mother Contracting Will Engender Exploitation by Middlemen"

Lifting the ban on birth-mother contracting rouses fears of ruthless exploitation of birth mothers and of adoptive parents by middlemen—specialists in bringing birth mothers and adoptive parents together. (See, e.g., Katz 1986: 7–18.)

Such fears are unfounded. Although horror stories are told of how corrupt middlemen prey on vulnerable birth mothers and adoptive parents,[19] the problems highlighted by the stories are an artifact of the law's refusal to legalize birth-mother contracting. Just as the gangsterish conduct of bootleggers during the 1920s was not indicative of the conduct of Anheuser-Busch, Seagram's, and other legitimate participants in today's legal market for alcohol, current unscrupulous actions of "baby brokers" in no way portend that legitimate participants in a legalized market for parental rights will behave unethically.

There are at least two reasons participants in a liberalized market for parental rights will perform honorably and in the best interest of all parties involved. First, legalized birth-mother contracting would give all market participants easy recourse to the courts for redress of untoward treatment. Liars, swindlers, and scoundrels under the current legal regime have little fear of being hauled into civil court by their victims. Second, legalized birth-mother contracting will subject to open competition all market participants. Middlemen who fleece and defraud their clients will, in addition to the threat of legal action, lose business to honest middlemen. Competition can be open only if it is legal, and—as in most markets—open competition is the best guarantee that all parties to the adoption process will behave, and be treated, properly.

In contrast, the current legal regime actually promotes exploitation by middlemen of birth mothers and adoptive parents. Adoption agencies are middlemen who profit from artificially high fees on the sale of parental rights—fees that birth mothers today are banned legally

[19]For example, see Baker (1978).

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from earning. Giving birth mothers and adoptive parents the legal right to contract with each other for the sale of parental rights will end exploitation not only by illegal "baby brokers" but by adoption agencies as well.

Of course, it is not clear that liberalized birth-mother contracting will create a demand for middlemen. Legally protecting birth-mothers' options of dealing directly with adoptive parents ensures that middlemen will survive only if they perform useful services. As long as the market for the services of middlemen is competitive, their existence and their actions are to be applauded rather than feared.[20]

Conclusion: Liberalize the Rules against Birth-Mother Contracting

Giving birth mothers the legal right to contract voluntarily with adoptive parents for the sale of parental rights in infants will not solve all the problems that today afflict child care and families. The surplus of older children, disabled children, and nonwhite children will not be alleviated by a freer market in adoptions. Nor will the dysfunctional U.S. foster care system be repaired. Many infertile couples will still not wish to adopt, and many pregnant women will still choose to abort. Nevertheless, a freer market in parental rights does promise great gains to adoptive parents, birth mothers, and children. These gains ought not be forsaken merely because the market cannot cure every evil or because we are uncomfortable with use of the language of economics and of commerce to explain how a liberalized market in parental rights will function.

Implementing such a market would not entail a great legal change. All that is required is that birth mothers and adoptive parents be allowed to contract with each other for the sale of parental rights in infants at mutually agreeable prices. Laws prohibiting birth mothers from dealing directly with adoptive parents and from selling their parental rights at mutually agreeable prices would be repealed, as would restrictions on birth-mother and adoptive-parent advertising. Current government-mandated screening of adoptive parents can be retained. Courts—which still will be required to issue a final decree of adoption in each case—can ensure that no one adopts without

[20]In reviewing an earlier version of the paper, Henry Sanborn correctly noted that a free market for parental rights will cause prospective adoptive parents to become much more selective about the characteristics of adopted children. The role of middlemen might expand to facilitate this selectivity. Intermediaries might also specialize in monitoring the prenatal care and habits of prospective birth mothers—many of whom might maximize their returns through association with intermediaries of good repute.

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having first passed a home study of the kind currently given to adoptive parents. Moreover, courts will keep whatever abilities they now possess to invalidate adoptions when adoptive parents turn out to be derelict or abusive. Cooling-off periods are also consistent with a freer market in parental rights: a birth mother can be given the right to reclaim her parental rights within, say, one week after initially turning her child over to the adoptive parents.

Indeed, nearly all regulations that today govern infant adoptions in the United States can be retained if birth mothers are granted freedom of contract. Reasonable people will disagree (as they do now) about which regulations are worthwhile and which are harmful. All that I propose is that birth mothers be allowed to contract freely with adoptive parents, with no restrictions on the prices paid for parental rights in infants, but subject to whatever other controls legislatures or judges deem appropriate. This modest change will yield enormous net benefits.

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BOOK REVIEWS

Myth and Measurement: The New Economics of the Minimum Wage
David Card and Alan B. Krueger
Princeton, N.J.: Princeton University Press, 1995, 422 pp.

This volume (beginning with its title) exudes hubris. The myth, which the authors promise to debunk, is that increases in the minimum wage have negative employment effects. This is to be replaced by a "new" economics of the minimum wage. Their book probes aspects of intellectual history, propounds some novel theoretical and methodological ideas, lectures its readers on technical aspects of econometrics, and prescribes public policy, despite frequent disclaimers.

In the introductory chapter, Card and Krueger resurrect the 1946–47 Stigler-Machlup-Lester debate on the role of marginalism in the analysis of wages and employment. Richard Lester, something of an apologist for the trade union movement, argued that marginalism was irrelevant, while Fritz Machlup and George Stigler claimed it was crucial. Card and Krueger unabashedly try to revive Lester's arguments. They praise him, dedicate their book to him, and complain that he has been neglected and too infrequently cited in the professional literature (while themselves ignoring Machlup). Their attempt at rehabilitation begins with a discussion of theoretical and methodological issues. The authors dismiss the marginal productivity theory that underpins the concept of the individual firm's downward sloping demand curve for labor; they dispense with aggregating employers' labor demands to produce a "market demand for labor," which would also be negatively sloped. Instead, they assume that all employers behave independently and function as monopsonists in the Joan Robinson mode. These few paragraphs are a substitute for a derivation of a model and a rigorous application of the model to empirical situations.

On the methodological front, Card and Krueger advocate the use of a technique that involves comparisons of the behavior of a sample group with some control group in "before and after" scenarios. They call these "natural" experiments and assert their superiority to the more conven-

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tional modes of analysis, econometric studies of time-series and cross-sectional data. Of course, both their natural experiments and the more standard analytical methods are simply different ways of attempting to satisfy the ceteris paribus conditions that are so critical in economic analysis. Why their method should be inherently superior is not obvious. As Card and Krueger describe them, natural experiments occur when there are two situations that are essentially identical except for a change in a critical policy variable. In such circumstances, they maintain that the ceteris paribus conditions are satisfied. The concept of natural experiments is useful, although the question of who is to decide whether they truly satisfy the ceteris paribus assumption is as difficult as the creation of adequate statistical controls in econometric analyses of data. Much more than a simple assertion is required to establish the superiority of one technique over another.

Chapters 2 and 3 present case studies of the use of this "new" methodology. Comparisons are made between employment in fast-food establishments before and after minimum wage increases in New Jersey (April 1992), Texas (April 1991), and California (January 1988). In each of these cases, the authors chose what they regarded as an appropriate "control group." For New Jersey, they chose fast-food establishments in eastern Pennsylvania; for Texas (in a study conducted by Lawrence Katz and Krueger), they chose fast-food firms unaffected by the April 1, 1991 increase in the federal minimum wage; and for California, they chose fast-food workers in Arizona, Florida, Georgia, New Mexico, and the Dallas-Fort Worth area in Texas.

The Pennsylvania-New Jersey comparison has drawn the most attention. In this case the authors chose to construct and use data obtained from a 24-question telephone survey. Only one question in this survey pertained to minimum-wage employment, and it is somewhat imprecise with respect to what constitutes full-time and part-time employment. The authors are to be commended for making their data sets available (in a sanitized fashion) through e-mail, but that is not enough. The quality of their data may be critically flawed so as not to satisfy the ceteris paribus assumption.

The Pennsylvania-New Jersey data were collected in two waves of telephone interviews, one before the minimum-wage increase (in February) and one after (in November). There are serious questions concerning the accuracy of that information. Studies using the official payroll records of fast-food firms in the relevant geographic areas had significantly different results and reached opposite conclusions. The major challenge has come from the Employment Policies Institute (EPI), which issued a report titled, "New Evidence on the Minimum Wage: The Crippling Flaws in the New Jersey Fast Food Study," in April 1995. EPI made its data available to David Neumark and William Wascher. They found that the employment effects of the New Jersey minimum-wage increase were negative and quite consistent with the prevailing wisdom.

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In the case of the payroll data, employers and the tax-collecting agency have strong financial incentives to ensure that the total dollar volume of payrolls is accurately stated. There is no such incentive for accuracy in the telephone surveys. Thus, there is a strong presumption of correctness in favor of the payroll data. We would urge the disputants in this issue to attempt to reconcile the two databases, perhaps by making them available in sufficient detail to enable some neutral third party, sworn to confidentiality, to exactly match the data, record the aggregate totals, and then destroy the individual firm information. Until the questions concerning the Card-Krueger data are resolved, their natural experiment analysis must remain suspect.

In chapter 6, Card and Krueger evaluate the validity of the various time-series analyses of the employment effects of minimum wages. They painstakingly reproduce and update several of the numerous studies that have explored the issue in that way. The sample of studies examined is limited and focuses on those with less robust statistical results. In choosing which ones to include in their examination, the authors claim to have used a "rigorous selection process." They invoke the 1982 survey article by Charles Brown, Curtis Gilroy, and Andrew Kohen, in which 26 articles are examined. They select *only* the 18 studies that examine the effect on employment, rather than unemployment. Next, they limit their analysis to studies that focus on "all teens," ignoring any analysis dealing with nonwhite, nonwhite male, or nonwhite female teens, groups where the effect of minimum-wage increases are much greater.

To those 18 studies, they add three more recent investigations to bring the total to 21. They then subtract 6 studies, those not using quarterly data, to arrive at their final sample of 15 studies. In an effort to discredit those studies they employ a variety of tests, such as regressing the square root of the degrees of freedom against the t-ratio associated with the minimum-wage variable. They conclude that, contrary to expectations, the t-ratio falls, rather than rises, as the sample size increases. However, an inspection of their regression results reveals that in no case is the relationship they observe statistically significant. Further, the scatter diagram they provide suggests quite strongly that without the inclusion of study number 15 (by Jacob Klerman [1992]) , the last study inserted, not even the negative regression coefficients would have been obtained. There is nothing about their results that is statistically robust, despite frequent claims to the contrary.

Despite the above mentioned shortcomings, the Card-Krueger findings have been seized upon, both in the United States and abroad, as providing support for increasing the minimum wage. Initially, there was a rush to judgment and a rush to celebrate and acclaim the results. With the emergence of major questions concerning the accuracy of the basic data in their major natural experiment, there has been some retreat from that position. We think this retreat is wise. Certainly, until some of the major questions are resolved, it might be well to accept the statement made by Krueger at a Milken Institute conference, where he stated, "I want

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to emphasize that my comments should not be interpreted as support for the position that increasing the minimum wage is sound public policy" (Krueger 1993:11).

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Beyond Politics: Markets, Welfare, and the Failure of Bureaucracy
William C. Mitchell and Randy T. Simmons
San Francisco: Westview Press and the Independent Institute, 1994, 234 pp.

This is the book I have been waiting for for at least 15 years. It is an eminently readable statement of the revival of political economy within the economics profession, as spawned by public choice scholars—such as James Buchanan, William Niskanen, Mancur Olson, and Gordon Tullock—some 35 years ago.

"Politics and economics cannot be separated," William Mitchell and Randy Simmons state in their preface. "Economies do not exist in a vacuum and neither do politics. Political systems shape, sometimes control, and often misdirect economic systems. Likewise, economic interests shape, sometimes control, and often pervert politics."

Those truths were accepted until about the 1920s, when theoretical "welfare economists" began devising elaborate theories of "market failure" that compared real-world markets to an unachievable utopian ideal called "perfectly competitive equilibrium." If the real world comes up short, as it inevitably does, the theorists condemn markets and call for government intervention. Renowned welfare economists such as Arthur C. Pigou and, several decades later, Paul Samuelson, Francis Bator, and William Baumol, paid no attention at all to the possibility that government might also "fail." "Imperfect" markets justified government control of the economy.

Until public choice theory revived the study of *political* economy, this biased method of analysis dominated the economics profession and still

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does to a large extent. Mitchell and Simmons begin exposing that bias in Part I of their book, "Market Failures and Political Solutions: Orthodoxy," where they carefully describe the various theories of market failure, including externalities, public goods, imperfect competition, macroeconomic instability, distributive inequities, and the existence of transactions costs. The authors reveal the anti-market mentality of welfare economists who advocate "more taxes; price controls; subsidies and tariffs; penalties for collusion; more controls over private property; and, of course, more government-directed planning."

Welfare economists are not the only ones to devise biased theories to "justify" their personal preferences for government intervention. Chapter 2 explains the role of the political science profession in creating an equally unrealistic and utopian vision of the political process. Political activism is supposedly "necessary for human moral development." Robert Dahl, an influential political scientist, has long contended that the more special-interest groups and government-imposed income transfers the better—because "countervailing power centers" will supposedly render politics "civilized, controlled, and limited to decent human purposes." Is there anyone who knows anything about how Washington actually works who could possibly believe that? Apparently, nearly the entire political science profession does.

Then there is the field of "public administration," founded by Woodrow Wilson, who believed that politicians and bureaucrats could be programmed to act as "scientific managers," faithfully serving the public without regard to their own self-interest. The only challenge is to provide these selfless creatures with enough "scientific knowledge." Public administration, Wilson argued, "is removed from the hurry and strife of politics" and even "stands apart. . .from the debatable ground of constitutional study."

This incredibly naive theory swept the public administration profession a century ago and is still dominant. Evidence of that dominance, the authors point out, is abundant: the 1992 presidential election digressed to a debate over whose central economic plan for the economy was best; Al Gore's book, *Earth in the Balance*, is a plea for central planning in the name of environmentalism; and in 1993, Rep. Gerry Studds proposed a bill that would create a National Biological Survey (NBS) of "everything that walks, crawls, swims, or flies around the country." The science adviser to the secretary of the interior explained in the *Wall Street Journal* that the purpose of the NBS was to "determine development for the whole country and regulate it all." (Didn't the Soviets try that?)

Part II of *Beyond Politics* is an eloquent presentation of most of the major tenets of public choice theory. Among the issues discussed in chapter 3 are why voters are rationally ignorant; why special interests dominate political decisionmaking; why politicians must pander to special interests at the expense of the general public in order to succeed in office;

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why public money is used to buy votes; why deficit spending is a politician's dream; and why bureaucrats bungle.

Chapter 4 consists of a more detailed explanation of "the anatomy of government failure," focusing on the "perverted incentives" that confront political decisionmakers under various electoral rules. After completing chapters 3 and 4, it is clear that however many "market failures" may exist according to the standards of welfare economics, applying those same standards to politics can only lead to the conclusion that government failures are far worse.

Part III of *Beyond Politics*—"Case Studies in the Anatomy of Public Failure"—surveys several areas of economics where public choice insights have been revolutionary. The authors explain why the so-called free-rider problem has been greatly exaggerated; why political control of markets leads to more, not less, monopoly; why there is a need for constitutional restrictions on the ability of politicians to plunder taxpayers; why "consumer protection" regulation often harms the consumer; why environmental policy has frequently degraded the environment while costing billions; and why politics renders macroeconomic "fine tuning" about as likely as a unicorn sighting.

In chapter 12, "Rediscovery of Markets, Competition, and the Firm," Mitchell and Simmons show how insights from the Austrian school of economics, especially the work of Friedrich Hayek, provide a devastating critique of the whole notion of market failure. If one understands competition to consist of a dynamic, rivalrous process of entrepreneurship, as the Austrians do, then the very business practices that have been condemned by welfare economists as inconsistent with "perfect" competition—advertising, mergers, product differentiation, and price undercutting, for example—are viewed as the very essence of competition. Government intervention can only impede the beneficial effects of market competition.

At this point Mitchell and Simmons should have introduced the work of the late Murray Rothbard, the Austrian economist who has made the most devastating theoretical critique of welfare economics. They also should have cited Roy Cordato's recent book, *Welfare Economics and Externalities in an Open Ended Universe*, and Tyler Cowen's edited volume, *The Theory of Market Failure: A Critical Reevaluation*.

Beyond Politics is must reading for all who wish to understand the political economy. It is the best exposition of public choice theory I know of for use in undergraduate classes, and it is filled with hundreds of references that will be especially useful to researchers who are new to the field. Mitchell and Simmons have produced a most valuable addition to the literature on the institutions of a free society.

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Privatopia: Homeowner Associations and the Rise of Residential Private Government
Evan McKenzie
New Haven: Yale University Press, 1994, 237 pp.

Privatopia provides a critical description and history of homeowner associations, including some of the important court cases regarding the enforcement of covenants. Whereas classical liberals would view private homeowner associations as a reflection of the principle of free association, the author, a political scientist and attorney, contends that such private organizations violate the ideals of choice and democracy. Evan McKenzie has "no quarrel" with the concept of "private land use arrangements," but believes the courts have granted homeowner associations too much power over their residents, and that the pursuit of profit by real-estate developers has transformed the originally utopian vision of social reform through the establishment of new communities into a mechanism for uniformity and excessive restrictions on property rights.

The development of residential associations (RAs), in which over 30 million Americans now live, was spurred by Ebenezer Howard's book, *Garden Cities of Tomorrow* (1902). RAs are a hybrid of Howard's utopian vision and "American privatism," hence McKenzie's term "privatopia."

The garden city was to be a new community made up of clusters around a central city, combining town and country. Howard envisioned voluntary associations financed by leaseholds, a concept that dates back to Thomas Spence in 1775. The ground rents would be paid to trustees, who would then turn over the balance of funds to the town council to pay for the community's public works. The architecture of the city would have a harmonious unity. The garden city was to be a model for the reform of society as a whole. In the United States, Howard's model influenced both land trusts, such as the village of Arden, Delaware, and residential associations.

The author contends that, despite the argument that members freely enter into contracts with RAs, they inhibit choice, since an increasing proportion of housing consists of RAs. But he ignores the fact that, first of all, choice is restricted in non-RA housing as well by government, including zoning, building codes, and laws governing personal behavior. The option of escaping all restrictions does not exist. Second, the RA rules that restrict can also protect; the prohibition of excessive noise, for instance, also protects neighbors' peaceful enjoyment of their property. Third, RAs offer the opportunity not just to add restrictions but to remove restrictions that apply to "public" but not private realms. For example, in a nudist club, the government's laws requiring clothing don't apply, and members join it to be free of those restrictions. In many cases, governments have not allowed RAs full control over their own property—for example, in the condominium in which I lived in Alexandria, Virginia, the city limited the number of people allowed in the pool area when there was no lifeguard, and the Virginia Condominium Act limits penalties

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for rule violations to $10 (Foldvary 1994). The issue, however, is not whether restrictions exist, but whether a person has freely agreed to a certain set of rules by contracting with other owners or with an organization.

Some of the practices that McKenzie illustrates are indeed problems, but their treatment in the book is itself problematical. He stresses that RAs are designed primarily to protect property values, but he does not seem to appreciate the principle that such values reflect market demand based on personal valuations of the services, rules, and amenities of a community.

As McKenzie states, RAs in the United States do indeed have a great deal of restrictive uniformity, contrary to the diversity suggested by the Tiebout model used by economists who study local public goods. In that model, based on an article by Charles Tiebout (1956) and subsequent literature, people choose an amount and type of local public goods by moving to communities that best meet their desires. But McKenzie does not delve deeply enough into the origin of RA uniformity. Tiebout is not even mentioned in the book.

As with other outcomes, one cannot, a priori, ascribe the problems of RAs to private enterprise, since the outcomes are a result of both market processes and government intervention. As McKenzie notes, developers built those communities "with government as a silent partner." One key reason for the uniformity is that the master deed and bylaws of RAs must be submitted to local planning authorities for approval, and also need approval by the Federal Housing Administration to qualify for its program to insure residential mortgages. The Government National Mortgage Association (GNMA or "Ginnie Mae") has also financed large-scale developments. McKenzie documents how the FHA promoted segregated housing patterns. Covenants that conform to "boilerplate deed restrictions" are most likely to get quick approval. But there are also communities such as Arden (a land trust rather than an RA) without architectural covenants, showing that such covenants are not inevitable. Also, governments have interfered by voiding provisions in the documents of private communities, reducing their private character and original intent.

Some of the abuses illustrated in the book do not even involve contracting. One RA claimed that an adjoining property was within the RA's borders and assessed the owner for a membership she had never agreed to. A judge ordered her to pay. The proper ruling would have been to remove her property from the RA jurisdiction, since it was not on the developer's land. Another problem, well noted by McKenzie, is that, in many cases, governments have reduced the liability of board members and developers—even though businesses are subject to civil tort liability.

McKenzie claims that the renters of RAs are disenfranchised. In condominiums only the unit owners can vote, but in RAs often tenants do vote. In the Reston Association in Virginia, each resident has a vote and each owner has a vote (owner-occupants having two votes). In Columbia, Maryland, residents as well as nonresident owners have a vote. Even in

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condominiums renters often have influence by serving on and chairing committees, by participating in meetings, and by enlisting the aid of their landlords. And, as Tiebout pointed out, renters, being highly mobile, can vote with their feet.

Another charge by McKenzie is what Robert Reich calls the "secession of the successful"—that is, common-interest developments (CIDs) serve the affluent, splitting society into segregated classes. However, some low-income housing has been built in RAs, there are low-income private neighborhoods in St. Louis, and some land trusts, not examined by McKenzie, cater to low-income residents. Still, CIDs have been mainly upper and middle-income communities because of double taxation. In most areas, property owners pay the same amount of tax whether or not they own and finance their own neighborhood streets, just as parents who send their children to private schools still pay taxes for government schools. If the RA members could deduct from their tax liabilities the normal costs of providing their own services, then lower-income neighborhoods could better afford to become private communities.

McKenzie also charges that CIDs have evolved a culture of nonparticipation instead of fostering the sense of community that Howard envisioned. But in my study of Arden as well as RAs, I found a great deal of voluntary community involvement, both in the committees that provide services and governance, and in the many clubs and charities that thrive in RAs.

Although McKenzie places responsibility for many of the RAs' problems on private agents rather than on government restrictions and privileges, his book is useful for those interested in homeowner associations and consensual communities. The legal and historical backgrounds are well laid out, and the problems he points out can serve as a basis from which reforms fostering more choice and better governance can be developed. The book is also an excellent source of information on the powerful impact that government agencies, such as the FHA, have played in American real estate.

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Conditions of Liberty: Civil Society and Its Rivals
Ernest Gellner
London and New York: Viking Penguin, 1994, 219 pp.

One of the most powerful rallying cries of those who overthrew socialism in Eastern and Central Europe was "civil society." It was both a slogan, a conceptualization of the alternative to socialism, and a program, as parallel structures—notably in Poland and in Hungary—were built alongside but independent of the state. The promise and the reality of "civil society"—the very "Bürgerliche Gesellschaft" so savagely attacked by Marx and his followers—systematically undercut the legitimacy of the socialist power structure, bringing down some of the world's most powerful states with barely a shot. Ernest Gellner, a noted Cambridge University anthropologist and director of the Centre for the Study of Nationalism in Prague, has devoted his attention in the past few years to the study of the twin legacies of communism—civil society and nationalism. He has written several books on nationalism; we now have his insights into civil society in *Conditions of Liberty*.

Denunciations of civil society for being "atomistic" have long been a staple of socialist rhetoric. Karl Marx had insisted that civil society is based on a "decomposition of man" such that man's "essence is no longer in community but in difference." Civil society, so the charge goes, separates man from himself, as well as from his neighbors, leading to alienation and atomization. But the experience of "real socialism" was that it led, in Gellner's words, "not to a newly restored social man, but to something closer to total atomization than perhaps any previous society had known." When the state absorbed society, it dissolved the normal bonds that tied humans together in civil society, leaving the awesome might of the state on one side and the naked individual on the other. The appeal of civil society is, *contra* Marx and his contemporary "communitarian" echoes, that it allows individuals to associate freely and thereby to increase their power, strength, and dignity in opposition to the state, which confronts them as an alien power.

Gellner is relentless in his critique of socialism, which is systematically stripped of its pretensions to moral superiority and to any claim to be the embodiment of freedom. As he points out, "In an industrial society, full socialism cannot but be totalitarian—and totalitarianism cannot but be socialist." Totalitarianism represents the triumph of coercion over production, whereas civil society attempts to tame power and direct it toward peaceful ends. The socialist taunt that the "bourgeois state was merely a kind of executive committee of the bourgeoisie" should be, according to Gellner, civil society's "greatest badge of honour": "The taming of power, its reduction to an instrument, one to be judged by its effectiveness and service, rather than allowing it to be a master—this is perhaps mankind's greatest triumph." Civil society is not merely a condition of political pluralism; premodern societies lacking centralized states (e.g., European feudalism) may also be pluralistic, but they are not thereby

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civil societies. Nor is civil society simply a condition of an individualized or atomized population, for certain Islamic societies (e.g., as described by Ibn Khaldun) neatly fit this mold, too.

In contrast, civil society manages at one and the same time to realize (1) checks on the awesome power of central states through countervailing power and mobility and (2) freedom for the individual, who is not smothered in the inescapable embrace of clan, tribe, or caste. Civil society rests on what Gellner calls "modular man," that is, on the freedom and opportunity to change one's loyalties, allegiances, and memberships without thereby becoming a traitor or an outcast from society generally. Thus, civil society allows "the forging of links which are effective even though they are flexible, specific, instrumental." Gellner echoes, without citing the reference, the famous claim of the classical liberal anthropologist Sir Henry Sumner Maine that "the movement of the progressive societies has hitherto been a movement *from Status to Contract*." The achievement of civil society represented, in Maine's terms, a situation in which "relations arise from the free agreement of individuals." Thus, the free-market economy, based on contractual agreement, is an element of civil society, as are freedom of conscience, freedom of movement, and other liberties of association.

One might expect that Gellner would heartily embrace the free market. But even piercing critics of socialism are sometimes caught in its embrace, and Gellner has unfortunately failed to examine some of the central criticisms of the market made by socialists to determine whether they are true. Specifically, the claim that fully voluntary orders are incapable of generating support for the unfortunate is taken over as an *a priori* truth by Gellner, when, in fact, it is false. The welfare state, without which a modern society would be, according to Gellner, "unutterably repulsive," has succeeded in atomizing large segments of Western societies almost as effectively as socialism atomized Eastern European societies. It has done so by eliminating those voluntary institutions that provide for mutual aid and the care of the unfortunate. For example, in Britain the friendly societies, which provided welfare support, mutual aid, medical care, and solidarity for millions of working class members, were completely wiped out by the welfare state, which systematically supplanted them. The effects have been starkly atomistic. And given the great rise in illegitimate births and the resulting suffering on the part of fatherless children, the welfare state can be justly accused of undermining one of the most important building blocks of civil society: the family. (David Green's work at the London-based Institute of Economic Affairs has done much to increase our knowledge of this history and of the effects of welfare statism.)

In addition, in every advanced welfare state there is growing conflict between young and old, as politicians have displaced voluntary retirement systems with compulsory Ponzi-scheme state insurance systems and made promises that the state is simply unable to fulfill. These conflicts show very frightening long-term potential for social disruption, as a glance at

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actuarial tables and the projected growth of the over-65 set in every welfare state will show. Over the long run, the welfare state may turn out to be almost as great an enemy to civil society as socialism has been. *Conditions of Liberty* is full of deep insights, careful arguments, and telling points. That the author does not see the threat to civil society posed by the growing welfare state does not diminish the value of his careful analysis of what makes modern liberty in civil society both possible and worth having.

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The Anatomy of an International Monetary Regime: The Classical Gold Standard, 1880–1914
Guilio M. Gallarotti
New York and Oxford: Oxford University Press, 1995, 347 pp.

"With a dose of nostalgia, the gold-standard period looks somewhat better to us than it did to contemporaries," Richard Cooper wrote in 1982. Both economists and politicians are still fascinated by this monetary regime. The preconditions for its partial or complete revival have often been examined at political as well as scientific levels—not only in times of bad monetary developments, such as inflation and currency crises and in connection with sweeping changes of the international monetary system, but also in the course of a general reorientation of the economic policy. In such times, a greater automaticity and stability in the management of monetary policy, a number of self-correcting mechanisms, and excellent monetary and economic performance have been considered to be the most important features of the international gold standard. Thorough economic analyses carried out by economists and monetary historians—Bloomfield (1959), Bordo and Schwartz (1984), Eichengreen (1985)—have long since relativized the blissful and simplified textbook view of the classical gold standard and its impact on national and international economic performance.

Interest in the gold standard was revived by the development of the research programs of transaction-cost economics, neo-Austrian economics, public choice economics, and constitutional economics, as well as the increasing importance of interdisciplinary approaches suitable for analyzing the functioning of national and international monetary regimes and their dynamics (durability and stability or transformation or breakdown). Gallarotti's book falls into this category. He uses an interdisciplinary approach to examine the classical gold standard as an economic regime in its political and economic framework. He tries "to integrate political, economic and ideological factors in explaining patterned behavior in international systems" (p. 3).

He does not expound the connection between economic performance and monetary regime; nor does he pass judgment on it. On the contrary,

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his book is centered around the following questions: Why did the gold standard develop as an international regime? Why did the classical gold standard last for three and a half decades? And how did it work?

The working hypothesis is based on the following context: the existence of an international classical liberal consensus (norms of monetary orthodoxy, norms of fiscal restraint and small public sectors, limited political involvement in economic matters, and the free flow of goods, factors, and investment) led to the convergence of the expectations and behavior of private and public actors, the credibility of the regime, and a stable market-driven structure of adjustment. Gallarotti's introduction is both a short guide to the rest of the book and a summary of results, whereas in chapters 2 to 7, the author gives reasons for his hypothesis. The book's structure is well arranged to suit the author's purposes.

In chapter 2, Gallarotti reexamines the properties of the classical gold standard in light of the regime approach. Those properties are characterized by the dominance of market processes and rather insignificant public intervention in markets for goods and money at domestic and international levels: a decentralized allocation model of liquidity, short-term capital flows as a means of adjustment, stabilizing speculation, the absence of capital controls, and widespread confidence in the regime itself. In the following three chapters, the author states the reasons traditionally given for starting and stabilizing the classical gold standard and invalidates them to a large extent. There was no institutionalized cooperation among central banks. Although several large international conferences among national governments were held to discuss and to negotiate the currency affairs, they did not bring about formal cooperative schemes. "Problems of Britain's intransigence, moral hazard, and fear of free-riding behavior produced a situation which prevented nations from collectively achieving desired goals" (p. 85).

Gallarotti also shows that neither the British state nor the Bank of England could be considered the leaders of the classical gold standard. The author derives that interpretation from the behavior of British delegations at international conferences, from Parliament's and the Foreign Office's handling of currency matters, and from the state's very limited contacts with international banking and investment. Moreover, he could find no indication either that the Bank of England acted as an agent of the British state or that the Bank itself directly (as the manager of the international monetary regime) or indirectly (through the British financial market) exercised hegemony.

Having repudiated hegemony and cooperation as the stabilizing forces of the classical gold standard, Gallarotti explains, in the next two chapters, first its origin and then its persistence in terms of the regime theory. He distinguishes between structural forces (status of gold, economic development and industrialization, growing trade, internationalization of finance, the political rise of an urban industrial class), proximate catalysts (the emergence of a nervousness over conditions prevailing in the market for metals, trade and monetary interdependencies linking the monetary

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standards of nations), and specific short-term pressures (the development of capital markets and central banking institutions, fiscal and monetary outcomes) that in the last third of the 19th century caused many nations to give up silver and bimetallist standards in favor of the gold standard. A new international monetary regime was never planned, agreed on, or dictated. On the contrary, similar framework conditions and increasing economic and monetary interdependencies brought about a change of the domestic monetary regime.

Why was the gold standard successful in maintaining itself? Gallarotti offers a clear two-tier answer. The prevailing economic ideology in the form of classical liberalism was the basis of a stable structure of adjustment. The international framework was stabilized through keeping rules at national levels. "The success of the gold standard was ultimately and inextricably tied to the success of classical liberalism" (p. 215). The stable structure of adjustment was possible because monetary relations were embedded in relatively stable international political relations; because the international economy was stable too; because the core nations (Great Britain, France, Germany, the United States) reduced their surpluses by importing goods and imposing few controls on capital exports; because there was a convergence of macroeconomic performance; and because investors regarded exchange and convertibility risks as low. Investors' inelastic expectations enabled elastic short-term capital flows that became the mechanism of adjustment.

Finally, in chapter 8 the author elaborates the properties of hegemonic, cooperative, and diffuse regimes. Gallarotti lists the (few) hegemonic and cooperative elements of the gold standard described in earlier chapters and conclusively identifies the classical gold standard as a diffuse regime (decentralized, self-enforcing, and with little need for management). "Credible rules may function as a sufficient substitute for cooperation and hegemony in the international political economy" (p. 235).

Gallarotti has succeeded in writing a very stimulating book. Not that the history of the classical gold standard needed to be written anew. Some of the findings in the book are already known. Sometimes the reader gets the impression that the old textbook view serves as a reference model (e.g., when the adjustment process is explained). However, the author convincingly succeeds in describing the regime dynamics in a comprehensive and consistent way. It would be extremely interesting to apply Gallarotti's approach to further case studies (e.g., the Bretton Woods period and the European Monetary System), to examine whether his far-reaching conclusions are valid for the current international monetary regime (global and regional), and to derive proposals for reforms.

The book is very thorough. It contains many references and a statistical appendix. A large number of original documents were used. In my opinion, however, there are too many summaries. There is a summary at the beginning and at the end of each chapter as well as in chapters 1 and 8. There are also summaries of each subchapter. But none of that alters the fact that this book will be a very valuable reference volume for experts

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and newcomers to the gold standard, for monetary economists, and for students of economic history, economic policy, and international relations.

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No Harm: Ethical Principles for a Free Market
T. Patrick Burke
New York: Paragon House, 1994, 249 pp.

It was once the case that defenses of the free market were predominantly made from an economic perspective, with the ethical discussions added almost as a side consideration. In some instances, however, as in Milton Friedman's great work *Capitalism and Freedom*, ethics played a larger, though still secondary, role. Recent years have seen the tide move the other way. Defenses of free markets now appear with relatively little reference to economic theory or research. Speculating on the reasons for this change would deter us too greatly, but Patrick Burke's new book could be described as a kind of mirror image of a work like *Capitalism and Freedom*. Burke's book is mostly about an ethical defense of free markets, but it also refers to a significant amount of economic literature in defending its conclusions. That mix is well integrated by Burke and certainly gives the theoretical ethics a good deal of substance.

The title of the book suggests, of course, John Stuart Mill—the most famous purveyor of a harm principle. Like Mill, Burke desires his ethics and economics to be integrated, and a harm principle would appear to be the seam upon which they are unified. Yet unlike Mill, the metaethical foundations of Burke's (no) harm principle are less clear. This may be a good thing; Burke need not be bothered by the psychological and anthropological principles that underlie Mill's hedonic calculus and often encumber his ethics. Yet without those underpinnings, it is not always clear whether the conclusions fashion the no-harm principle or the principle generates the conclusions. In any case, Burke generally avoids broader philosophical commitments for the sake of more directly ethical and political considerations. This gives his no-harm principle a kind of founda-

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tional quality—it, or what directly follows from it, is meant to do all the work.

The work the principle does is directed at topics clustering around the notion of markets and market exchanges. The topics range from just prices to drugs, from coercive exchanges to monopoly pricing, from market failure to obligations of charity. Virtually every chapter contains prescriptions for public policy as well as discussions of a more abstract nature. The no-harm principle seems to be employed in deciding everything from the meaning of fairness to the ethics of taxation. In this respect, Burke, like Mill before him, seems to saddle himself with the burden of having one principle solve every social-political question. Whether any single principle can bear all that weight is an open question, but it is perhaps most problematic when no broader philosophical traditions are drawn upon to anchor the theory.

No real positive defense, for example, is provided for the no-harm principle (again suggesting its fundamental nature). We are simply launched into its meaning and implications. The procedure thus seems to be to undermine any intuitions or arguments to the contrary, leaving the no-harm principle (and its implications) as the only principle left standing. The problem here, though, is that any competing positions are themselves undermined by the no-harm principle, making the whole project look somewhat circular—a procedure that may possibly be legitimate if the no-harm principle is itself a first principle. In any case, the principle is said to imply a host of libertarian/classical liberal conclusions, so one could regard Burke's project as a working out of the logic of such a principle and how it might respond to some of the more significant claims against it, rather than as an attempt to derive libertarian principles from a theory in basic ethics.

The no-harm principle itself has two main conditions: (1) one must be made worse off after an action than one was before it, and (2) only actions that directly cause or produce the first condition will qualify as harming actions. Failure to act or having one's condition worsened by impersonal powers (e.g., economic forces) does not qualify as causing and therefore as harming under the second condition. A large part of the ethical arguments of the book are spent on various rebuttals to the idea that failure to act or market processes cause someone harm. There are a number of valuable discussions along these lines, especially when it comes to the economic dimensions of the argument. Moreover, the emphasis on direct causation is certainly a worthy one. But that emphasis seems both at times misapplied and misplaced. Consider first blackmail. We are told that it involves a threat to cause someone harm and thus violates the no-harm principle. But here the application of the causal condition seems misapplied. I am not a cause of any lessening of your condition by suggesting I'll tell your spouse about your extramarital affair. Your spouse, not I, will be the only causal agent by the conditions of causality specified by Burke.

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As to misplaced emphasis, there are at least two problem areas. First, Burke is more concerned about defining the meaning of "causation" than of "worsening" one's condition, i.e., he is more concerned about the second rather than the first condition of the no-harm principle. This is probably because the first condition is too messy to adequately control. At one point he tells us, for example, that only those things that "impair the integrity of the person" will count as harms or losses (p. 193). What exactly this means is undoubtedly at least somewhat ambiguous. If we do give it a great deal of substance, we could probably criticize blackmail but, in my view, at the expense of Burke's causal principle.

Second, notice that the no-harm approach seems not to be one based on rights. This is important because there is no necessary connection between rights and what are ordinarily called harms. One may have one's rights violated without being harmed (indeed one could even become better off ["if he hadn't broken into your house, you wouldn't have captured him and gotten all that reward money"]), and one may be made worse off without one's rights being violated. Consequently, either a notion of harms or rights will be fundamental, and one expects from Burke that the work will be done by harms (or more accurately, no harms). Unfortunately, all sorts of things fit the two conditions for harming that we would and should allow, e.g., telling the truth about someone to their economic detriment (p. 58).

This suggests there is a difference between justified and unjustified harming. We are told, however, that the no-harm principle is the only absolute value (p. 189), suggesting that it must be the basis for determining the difference between what is justified and unjustified. But either the no-harm principle works in light of some other moral commitment or it does not. If it does, then we should be clearer about that other standard and how it helps us discriminate between justified and unjustified harming. If it does not, then, except in cases of retaliatory harming for violating the no-harm principle itself, we should be able to use the principle to determine the difference between the rightful and wrongful, the justified and unjustified. But the principle itself seems to depend upon the prior existence of such distinctions. The admonition of the principle is not "do no harm," but only "do no wrongful harm."

There is some indication that, the foregoing claim about absolute value notwithstanding, the whole project is meant to rest on ordinary moral intuitions, or "common conceptions of morality" (pp. 181ff). Fair enough. But what we find here is less an unpacking of ordinary moral beliefs than an attempt to reform them. Many of these reformations deserve our allegiance. Nonetheless "harm" is too broad, fuzzy, and derivative a notion to do the work expected of it here. Part of the problem comes, of course, because to speak of harms is to have to pay attention to being better and worse off. This is inherently ambiguous (at least for ethicists, if not economists) in a way rights are not. For while there may be many disputes in theories of rights, the end product of any given theory is never itself subjective. Harms, by contrast, can never escape the subjective element.

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Whether a person is better or worse off seems in the end to at least partly depend on the person's own attitude about his condition.

The reader's confusion is only compounded when Burke talks of punishment, a subject he apparently takes as important to the book's thesis. We are told that "all laws inflict punishment" (p. 40), presumably including laws that accord with and protect the no-harm principle itself. The circularity problem seems to be present here as well, and distinctions between being punished and penalized, harmed and injured would probably have helped to alleviate confusion.

But Burke is certainly correct about us having a basic antipathy toward harming innocent people, and in this respect the book is quite helpful in pointing out ways in which harm may be done and the political implications that follow therefrom. For those unfamiliar with markets, economic issues, and the interface that can occur between ethics and economics, the book should be especially valuable. There is much to be said in favor of a project that seeks to put the free market in line with people's basic moral convictions, and in this respect at least Burke's book makes a valuable contribution.

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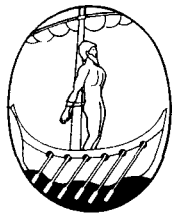

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ELEMENTS OF A MARKET-LIBERAL ORDER

The extent to which the political-social-economic system provides personal freedom from government coercion is a crucial element in the economics of resources and population. Skilled persons require an appropriate social and economic framework that provides incentives for working hard and taking risks, enabling their talents to flower and come to fruition. The key elements of such a framework are economic liberty, respect for property, and fair and sensible rules of the market that are enforced equally for all.

—Julian L. Simon

The State of Humanity
(Cambridge, Mass.: Blackwell, 1995), 26.

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